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RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND SELF-SUFFICIENCY ACT OF 1983

HEARINGS

BEFORE THE

SUBCOMMITTEE ON AGRICULTURAL CREDIT
AND RURAL ELECTRIFICATION

OF THE

COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

S. 1300

TO AMEND THE RURAL ELECTRIFICATION ACT OF 1936 TO ENSURE THE CONTINUED FINANCIAL INTEGRITY OF THE RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND, AND FOR OTHER PURPOSES (RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND SELF-SUFFICIENCY ACT OF 1983)

MARCH 20, APRIL 12, AND MAY 15, 1984

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RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND SELF-SUFFICIENCY ACT OF 1983

TUESDAY, MARCH 20, 1984

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL CREDIT
AND RURAL ELECTRIFICATION,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 328-A, Russell Senate Office Building, Hon. Paula Hawkins (chairman of the subcommittee) presiding.

Present: Senators Hawkins, Andrews, and Zorinsky.

Also present: Senators Huddleston and Pryor.

STATEMENT OF HON. PAULA HAWKINS, A U.S. SENATOR FROM FLORIDA

Senator HAWKINS. Good morning.

Today's subcommittee hearing will focus on the financial problems of the Rural Electrification and Telephone Revolving Fund. This morning we will hear testimony on S. 1300,[1] the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983, a proposal to resolve these financial difficulties.

The Rural Electrification Program was established in 1935 to bring electricity to farmers and their families in rural America. At that time, fewer than 12 percent of the farms in the United States were receiving electric service, but through public and private cooperation, electric service spread to more and more rural residents. In fact, 99 percent of America's farmers are now being served by approximately 1,000 locally organized and operated rural electric cooperatives—a truly amazing success story.

The Federal Government's involvement in rural telephone service came later, in 1949, when the Rural Electrification Administration was authorized to lend funds from the U.S. Treasury for the purpose of furnishing and improving rural telephone service. At that time, only 36 percent of rural farms had telephone service, but, as in the Rural Electric Program, rural telephone service continued to expand so that today 95 percent of rural farms have telephone service.

For many years, the Federal Government's contribution to these worthy programs was in the form of Treasury loans made directly to the cooperatives, loans subject to REA's evaluation and approval. But, in 1973, Congress replaced this system of direct financing from the Treasury by establishing the Rural Electrification and Telephone Revolving Fund, administered by the REA.

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[1] See p. 453 for a reprint of S. 1300.

The Fund was established by temporarily assigning $7.9 billion in outstanding loans from the Treasury to the Fund. Since that time, however, the financial position of the Fund has been eroding. For years, the Fund's income has been insufficient to fund new loans, so the Fund has been forced to borrow from the Federal Financing Bank, at interest rates substantially higher than the 5-percent rate charged on REA loans financed through the Fund. As a result, the Fund's interest expense will exceed interest income in 1986 and the Fund will need appropriations by the year 2002 to continue operations under current law.

Before us today is one proposed method to solve the financial difficulties of the Revolving Fund, S. 1300, introduced by the distinguished Senator from Kentucky, who has joined us, Mr. Huddleston. So this morning we are going to look at the problem and how S. 1300 would solve the problem. Today and through a subsequent hearing, we will review the strengths and the weaknesses of this legislation. Having reviewed the previous positions of today's witnesses, I believe we will hear differing views on the potential impact on the Treasury, the telephone and electric cooperatives, and the consumer. Hopefully, we can get to the facts of the issue so that we can take whatever action is necessary to ensure that rural America continues to receive electric and telephone service at reasonable rates.

As a former public service commissioner for the State of Florida, and a former member of the Rural Telephone Bank Board, I can speak from experience about the importance of ensuring that rural residents receive these vital, often life-supporting services. As subcommittee chairman, I pledge my full support for responsible and appropriate Federal involvement in helping provide continued electric and telephone service to rural America. I believe everyone in this room shares that commitment, regardless of their position on this particular bill. And, with this commitment in mind, we look forward to today's hearing.

Senator Huddleston, do you have an opening statement?

STATEMENT OF HON. WALTER D. HUDDLESTON, A U.S. SENATOR FROM KENTUCKY

Senator HUDDLESTON. Thank you very much, Madam Chairman.

First of all, I am glad to see you back and out and around after your recent accident. I am glad that you are hearty and hale and can withstand those little minor setbacks.

Madam Chairman, I would like to make a statement, but will have to step out very shortly for a few minutes. I will return and I certainly will be interested in hearing the testimony of the witnesses. I would like to submit questions to those who will complete their testimony before I return.

As you have indicated, the bill that we have before us, S. 1300, will amend the Rural Electrification Act of 1936 to ensure that the Nation's rural electric and telephone systems will be able to continue to provide high quality, affordable electric and telephone services to consumers in rural America.

A major source of financing for rural electric and telephone systems, the Rural Electric and Telephone Revolving Fund administered by the Rural Electrification Administration, is in jeopardy. The solvency of the Fund is threatened because of the high interest rates in recent years.

Congressional action is needed to keep the Revolving Fund self-sustaining and otherwise enable the rural electric and telephone systems to obtain adequate financing for their operations. Without legislation to restructure the REA Loan Programs, in the near future, there will be only two options: Bail out the fund with tax dollars, or greatly curtail the only source of financing for many rural electric and telephone systems.

If the assistance provided through the REA Revolving Fund is curtailed, financing costs will escalate and put additional upward pressure on rural utility rates. On the average, consumers in rural areas already pay higher utility rates than city dwellers because of the high cost of providing service in areas of low population density. In terms of cost, S. 1300 will not require increased Federal outlays. Further, it will eliminate the need for appropriations that would otherwise be required to cover the difference between interest income and interest expense to the REA Revolving Fund.

By raising the interest rate that borrowers will pay in providing an adequate capital base, S. 1300 will reduce Federal borrowing. In doing so, the bill will contribute to our efforts to hold down spending for Government assistance programs.

One of the key provisions of S. 1300 is the reclassification of $7.9 billion in notes due to the Treasury, beginning in 1993, as equity for the Revolving Fund. This reclassification will have no budget effect because, if it is not done, the REA Revolving Fund will have to borrow funds, through the Treasury's Federal Financing Bank, to make those payments and to continue to provide financing through the REA Loan Programs at present levels.

Some opponents of the legislation have tried to characterize the reclassification provision as a forgiveness, and this is simply not the case. The fact is, such conversions of debt to equity are common in the business world, and are considered prudent investment decisions. Frequently, investors holding bonds with conversion features exercise their option to convert bonds into equity in the form of stock. These individual investors have not given anything away, or given up control of their investments. And the same will be true for the Federal Government under S. 1300.

Finally, I want to add that I am pleased with the support that this legislation has received. There are now 42 Senators cosponsoring S. 1300, including a majority of the Agriculture Committee.

I commend you for holding these hearings, Madam Chairman, and I look forward to reviewing the testimony of today's witnesses. If you will excuse me, I will be back in a very short time.

Senator HAWKINS. Thank you, Senator.

Senator Pryor?

STATEMENT OF HON. DAVID H. PRYOR, A U.S. SENATOR FROM ARKANSAS

Senator PRYOR. Thank you, Madam Chairman. Before Senator Huddleston leaves, I would like to thank him for his leadership on this issue in bringing S. 1300 to the Senate and to this committee. I am pleased to be a cosponsor of this legislation, Madam Chairman, and I am very proud that you are holding this hearing this morning so that we can hear about an issue that in many quarters, I think, has been misunderstood and misinterpreted.

I want to first say that within the leadership of the various organizations affected by S. 1300 are some people from Arkansas. Mr. Carl Whillock and Mr. Jack Williams served on the National Rural Electric Cooperative Association Committee on Financing for the Future. Mr. Williams is here with us this morning. It is altogether fitting, I think, that Arkansans play a role in the future of the Rural Electric Administration, since former Representative Clyde Ellis was one of the founding fathers of REA. He saw his dream become a reality during the Roosevelt administration. And we are very proud of the late Congressman Ellis' role in this vital area of bringing utilities to the people of rural America.

This legislation before us today, Madam Chairman, affects the lives of 25 million people in rural America. It affects the lives of some 260,000 Arkansas families who live in rural America. And should this legislation not pass, and should substitute legislation which would cause higher utility rates happen to pass in this session of Congress, we would see, in my opinion, a death blow being dealt to farmers across America. Without this legislation, this program would face a crisis that would quickly be felt throughout America. Instead, we feel that S. 1300 provides a very carefully balanced proposal to avoid a crisis, and to make an orderly transition toward self-sufficiency.

In brief, S. 1300 would, one, give new authority to the REA Administrator to make periodic adjustments in interest rates on loans; two, convert Treasury notes that would fall due between the years 1993 and 2017 into equity capital for the Revolving Fund; three, it would provide for lien subordination or accommodation to assist in obtaining commercial loans; and, four, it would make adjustments in the electric and telephone programs that it serves.

This legislation assures that rural citizens in the States of Florida, Arkansas, Kentucky, and all across America will be able to keep pace with the progress that will take place in communications and electric power technology, service reliability and increased affordability of these services. These cooperatives provide services to people. Senior citizens in geographically isolated areas need reliable heat, lights, and telephones for their health and safety. Reliable, affordable utilities provide immeasurable security to farm families and, moreover, these services can increase the productivity and enhance economic development while, at the same time, improve the conditions and the quality of life in rural America.

Madam Chairman, once again, thank you for chairing these hearings. I hope that this committee, the Senate and the President will act promptly and favorably on this very, very important legislation.

Thank you.

Senator **Hawkins**. Thank you, Senator Pryor.

Senator Jepsen is a member of the subcommittee. He desired to be here today; however, he is chairing an Armed Services hearing this morning.

In addition, Senator Helms is chairing a hearing in the Foreign Relations Committee. But they all have statements for the record and, without objection, we will include them in the record.[1] In fact, the record will stay open for all the Senators who desire to enter a statement for the record.

The first panel of witnesses this morning is the Honorable Frank Naylor, Under Secretary for Small Community and Rural Development, U.S. Department of Agriculture. He is accompanied by the Honorable Harold Hunter, Administrator, Rural Electrification Administration, U.S. Department of Agriculture.

Do you have a statement, Mr. Naylor?

STATEMENTS OF HON. FRANK NAYLOR, UNDER SECRETARY FOR SMALL COMMUNITY AND RURAL DEVELOPMENT, U.S. DEPARTMENT OF AGRICULTURE; AND HON. HAROLD HUNTER, ADMINISTRATOR, RURAL ELECTRIFICATION ADMINISTRATION, U.S. DEPARTMENT OF AGRICULTURE

Mr. **Naylor**. Madam Chairman, it is a privilege to be with you today, and we are glad to see that you did survive that accident with a minimum of injury, and to see you hale and hearty, in full gear again promptly.

I have just a few opening comments, if I may, and then I will defer to Mr. Hunter for the purpose of making an opening statement.

The Rural Electric Administration has a valued and long and commendable record in this country in providing electricity and telecommunications for rural America. It is perhaps one of the great success stories in America in the job that it has done and, in fact, will continue to do in the future.

We continue to support that program. We continue to propose funding that will meet its needs, to adequately fund the demands that are out there for service, particularly to our more rural and needy areas where density is still a major factor and concern.

I think it would be tragic if, in the process of these hearings there is any misinterpretation that an honest disagreement between men of good faith on how we approach the techniques of financing and funding this agency as a Federal entity, would be construed as not being supportive of the agency and of rural America in the form of the funds needed for more rural electrification and, of course, telecommunications. That would certainly not be the case.

The proposal which we are reviewing today is one of several that has been discussed and, are before Congress, ways to approach the problem of the Revolving Fund and providing it long-term stability. Regretfully, the proposal that is before us today has a very substantial attendant cost to it. While we can describe in various ways the proposal that is before us today as not really being of any cost to the Government, the fact remains that, in one form or another, it will ultimately cost the American taxpayer, including the rural electric users, an additional prospective, approximate $21 billion. This comes, in large measure, from forgiveness of the repayment of capital to the Treasury in the form of $7.9 billion, a debt that had been scheduled for retirement beginning in 1993.

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[1] See p. 151 for the prepared statement of Senator Helms and p. 152 for the prepared statement of Senator Jepsen.

Regrettably, and with due respect to Senator Huddleston and Senator Pryor, we cannot escape the fact that the debt will not be retired if it is forgiven. It, in fact, will have to be reborrowed and that debt scheduled for retirement will, in fact, remain in place and represent actual cost to the taxpayers beginning 1993.

There are other major provisions of the bill involving one-way interest rate structures that will make up the bulk of the remaining estimated $21 billion ultimate cost of this proposed legislation, if it were passed in its present form.

Because of this and because of the need to consider additional alternatives in a very careful and studied way, we have found it necessary to advise the committee and Congress that if the bill in its present form is passed, we will, in all probability, recommend to the President that he seriously consider vetoing the bill.

Madam Chairman, we have looked and continue to look for ways to deal with and maintain and strengthen the Fund. I think it is important also to recall that what is at issue here today is not whether or not funds will be available to meet the needs of rural Americans in telephone and electrical service, nor is it a question of whether or not those that have borrowed will repay, because the repayment record is outstanding, and certainly has never been nor do I think it likely that it will ever be in question. What we are dealing with essentially here today is a technical issue within the Federal establishment on how we best maintain the solvency of the Revolving Fund, from which funds are drawn to make the loans to rural America.

The proposal we have before us is one of a number of ways that issue can be dealt with. Unfortunately, in our view, with the present situation of severe Federal deficits, the need to practice restraint in Federal expenditures, and the need to recognize that those entities which are strong financially should not look to a vehicle that bears the potential of extensive costs that this particular legislation does, we should continue to look for other ways in which to deal with this problem in a longer term fashion.

I appreciate very much the opportunity to make a few opening comments. Mr. Hunter has a more detailed statement, with more specifics with relation to legislation, and I would ask your permission that he now make that statement.

Senator HAWKINS. I see that Senator Andrews has joined us. He is on a tight schedule like everyone else. Would you like to give your statement now, Senator Andrews?

Senator ANDREWS. I do not have a statement. I have a few questions when Mr. Hunter is done.

Senator HAWKINS. All right.

Senator ANDREWS. Thank you, Madam Chairman.

Senator HAWKINS. Mr. Hunter.

Mr. HUNTER. Again, Senator Hawkins, I want to add my pleasure in the fact that your misfortune did not affect you any more than it did. I appreciate the fact that you can be with us here this morning. You seem to be doing well.

If I may, I do have a prepared statement which has been distributed to the subcommittee. If I may, I would like to stray from that because I think it would help us to address some of the things that are of more concern to us. Since the written portion is available, we recognize the time constraints that you are all under, in the Senate in particular, and, if I may, I would go that route.[1]

Also, as I get a little further into my remarks, I would like to request that one of my staff, Larry Belluzzo, be allowed to show some charts which give a graphic display of some of the facts that relate to the issue that we have before us.

Several comments have been made already this morning which I think very appropriately point out that we cannot disassociate REA from this issue, or from the overall economy in which we are operating at the present time. We cannot disassociate it from the effort that is being made toward economic recovery. As a farmer from out in Oklahoma, I am convinced we have made some great strides toward economic recovery. Certainly, the farming industry is in trouble. The farming industry has a serious situation to deal with at the present time. We know this relates to several phases and several factors in the economy. But, also, if we think for just a moment, about what might be if interest rates had continued to escalate like they were escalating some 3 years ago; if inflation had continued to be as great a threat as it was 3 years ago; and, looking at it as a wheat farmer and cattleman out in Oklahoma, I could envision a situation far worse than it is today. And, in light of that, I am pleased that as much progress has been made toward economic recovery as has transpired.

In the same breath, I am convinced that a lot yet needs to be done. We have a foundation laid with the improvement that has taken place, but we must go the other step. And part of going that other step is how each agency within the Federal Government conducts itself; to what degree does each agency operate its programs in the most efficient, the most careful, the most prudent way it can. I think each piece of legislation must be looked at in the same light, of whether or not the cost to the Government is a necessary cost; whether it definitely has to happen; or whether it is one that can be avoided.

I think this is one of the larger issues we have here today. And, again, as Mr. Naylor has said, I see no reason that we cannot disagree if we are working toward the same end. And I think we are working toward that same end. We are wanting a Rural Electric and Rural Telephone Program for the future to continue to be a viable and effective service and a real undergirding to the industries we all know are important.

So, on the basis of that, as administrator of REA, it is impossible for me to separate our consideration of this legislation from the overall economic situation, and the necessity we have to support the great efforts that have already been made, and which are continuing to be made, and are part of the difficulties that face everyone of you today in your responsibilities in the legislative arena.

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[1] See p. 157 for the prepared statement of Mr. Hunter.

I do compliment you, Madam Chairman, and also the other members of the subcommittee, for this hearing, because I think a real factual understanding of what we are doing will help us toward the judgment that we should exercise. And this is a complex bill. This is a complex piece of legislation. It addresses some difficulties which need to be addressed. This is one of the areas that we can start with and agree on; there is legislation needed. The situation that we live with at the present time, the 5 percent interest rate mandated by the statute, is part of the problem, and we will address that further as we go along.

So, as we speak about an act which is entitled "Self-Sufficiency," I think it is important that we address the question of how can we make REA, as an agency, be self-sufficient in the needed service to the industry that it supports. And this is one of the major questions before us. The legislation addresses interest rates. We recognize as we look back at history, that when they set the interest rate at 5 percent, it was rather logical, because the cost of Treasury borrowing was 6 percent. That disparity could be tolerated by the Revolving Fund itself, because of the resources within it. But, in the same breath, we come to a proposal here that provides that under certain guidelines, the Administrator will set interest rates, and the initial level of those interest rates will be about 6 percent. This is a raise of only 1 percentage point from the 5 percent that we have today when the cost of Treasury borrowing is approximately 11 to 11½ percent. The Revolving Fund still does not have within itself resources or capability to tolerate this disparity. We feel these proposed interest rates do not reach adequate levels.

Now, let me address as I think several have already addressed, the question of what the impact will be upon the user at the end of the line, because that is who we are serving. That is who our responsibilities relate to. So we have looked at this very carefully and we have analyzed it and, of course, we used averages. Averages do not tell the whole story of the disparity between averages, the disparities between the high and the low, but you have to start somewhere. Let's look at the average impact raising this interest rate will have upon the user at the end of the line, the residential user served by a cooperative somewhere in this great Nation. We find that on an average, each percentage point of increase in interest rate charged by the REA on those new loans made by the Revolving Fund impacts the user at the end of the line approximately a half a penny a day—half a cent a day. When you look at that, you recognize that it is a minimal impact.

Let us convert that a little further. Let us suppose, rather than going up 1 percentage point, we go up to within a couple percentage points less than the cost of Treasury borrowing. That would not be too burdensome. That is still a good arrangement for any borrower, to be able to borrow their capital funding needs at 2 percent less than the cost of Treasury borrowing. So we are talking at this time about a difference between 5 percent, which it is now, and approximately 9 percent. And doing a little subtracting, we have got 4 percentage points; if you multiply that half a penny a day times those 4 percentage points, you have 2 cents a day. And the easiest way to understand is to really convert it to that monthly bill. And multiplying those 2 percentage points times 30 days to get at the monthly level, we find we have an amount of 60 cents per month for the monthly bill adjustment in order to tolerate an interest rate of 9 percent.

This is probably less than the cost of one hamburger a month. It is not an intolerable increase, and it puts the cost where it ought to be if you are really going to call this a bill that has self-sufficiency in it. Because that is where the costs are allocated in this business, to the user out at the end of the line.

Mr. Naylor has already mentioned the refinancing, and I would emphasize that again, is an issue with which we do not agree. The refinancing downward only is an abrogation of a contract, because financing of our CBO's has been contracted to by REA. To change that will be to the disadvantage of Treasury, and will amount to some $8 billion over the life term of those CBO's.

We are agreed on several things within the bill. We agree on the need to change interest rates. We think there is some wisdom in the idea of separating the two funds. We think there is some reason to do that, to put electric and telephone in separate accounting situations. We see a need for some change in accommodations. We feel that this bill goes a little farther than would be wise; the mandatory aspects of the provisions bother us because we feel there are times when discretion and judgment of the agency should be used. But we are not disagreeing with the need for the legislation. We are not disagreeing on many of the items in the bill.

Let me address myself just for a moment to the history of how we got to where we are, because I think that becomes very pertinent to how we solve the problem.

For the beginnings of this thing, we go clear back to the early thirties. At that time, when this agency was created, it was charging 2 percent interest on the loans it made. And that sounds like a gravy train. That sounds like a great deal, but I think we need to remember that for those first 15 years of this program, when 2 percent interest was being charged, it was being charged on money that was only costing this Government a penny and a half interest. So we are talking about a loan being made without a fiscal or financial subsidy. The subsidy consisted of the availability of those funds rather than the interest rate.

The availability of the funds is still important. That is why REA needs to continue to be a viable agency, because REA needs to be present in order to assure the availability of funds, not necessarily to address itself to a subsidization or a relaxation of the cost.

I will jump up then to 1973, when legislation created a revolving fund. At that time, the interest rate was set at 5 percent. That was not an intolerable amount, because, again, the Revolving Fund has the capability to live with the differential between 5 and 6 percent. But, as time went along, escalation of interest rates got us into trouble; plus the load that was put upon the Revolving Fund was greater than had been anticipated.

So the problem relates to the level of those interest rates that are being charged to our borrowers. The problem can be solved by an adjustment in those interest rates, if it is done to an adequate level.

I would like to have at this time then, with your permission, Madam Chairman, to ask Mr. Belluzzo to show us some charts which will give us a little better understanding of the impact of the data we have studied.

Mr. Belluzzo has worked very carefully with a series of analytical approaches, having used the capabilities of computers to run some of these ideas and concepts out a long time in order to see what really can happen.

So, with him trying to provide that in a way that can be most visible to the most folk, I would like to have his comments made part of these presentations.

Senator HAWKINS. It will be better if you put it up here so we can all see your presentation.

Mr. BELLUZZO. Madam Chairman, when we were first given a copy of the proposed legislation last May, we began to modify our automative revolving fund model so that we could do a comprehensive analysis of how well the proposed legislation, and specifically the formula that is proposed in section 6, would work in actually setting the interest rates to be charged in the Revolving Fund. Our objective was to examine how well the proposal would actually function under a wide variety of average interest rate and growth scenarios, simply because we wanted to avoid what happened in 1973, when a flat 5-percent interest rate was installed in the legislation, and that, of course, has led to the problems we have today.

By any other name, section 6 establishes a formula. It does so because it defines the elements that are used in the computation of the rates, and it specifies how those elements are to be combined and manipulated in order to achieve a specified goal, which is to set interest income equal to but not greater than that which is necessary to retire interest expenses.

Exhibits 1, 2, and 3 in Mr. Hunter's formal testimony summarize the results of a small number of the simulations we ran testing the viability of this particular formula, using a wide variety of plausible interest rate and program growth scenarios.

The bottom line is this: without forgiveness of the $7.9 billion in long-term notes, this formula is virtually guaranteed to fail, since it purposely fails to set interest rates high enough to generate the income that you need to permit the repayment of the long-term notes.

But, even with the forgiveness of $7.9 billion and downward only refinancing of CBO's, we found that the fund would still become insolvent under most plausible scenarios for the same basic reason. Interest rates under the formula are set too low to enable the Fund to retire its debts.

These charts demonstrate what happens to the Revolving Fund interest rates and net notes receivable under a very simple scenario, which assumes a continuation of the status quo. In other words, a $1.1 billion program that does not grow over time, and an 11-percent CBO rate, which is fairly typical of what we had for the last year or so.

This chart demonstrates what happens to net notes receivable. Net notes receivable are the most handy barometer of the Fund's status, and are computed by taking the total amount of moneys that are owed to the Fund by the borrowers and subtracting the amount of money that the Fund owes to FFB and the Treasury in the form of certificates of beneficial ownership.

This particular chart shows you three different scenarios. One is what happens if we do nothing at all, and keep the RETRF rate at 5 percent. Over the next few years, the net notes receivable of the Fund will continue to increase at a very slow rate, as shown by the orange line. Within just a couple of years, interest expenses exceed interest income. The net assets of the Fund will begin to deteriorate as the principal of the Fund is eaten into to pay interest expenses.

Of more interest is what happens if S. 1300 is passed in full as shown by the red line.

We assume here a forgiveness of the long-term notes, the full $7.9 billion, and downward only refinancing of certificates of beneficial ownership to the 11-percent level. Under this scenario, the net notes receivable continue to rise and stay stable for some number of years longer than would be the case with no legislation at all. But eventually the accumulation of debts that the Fund owes on certificates of beneficial ownership would prove to be too much. The expenses of the Fund would exceed its income; we would begin to eat into the principal of the Fund and the Fund would, essentially, go insolvent, or be unable to continue at the same program size level, by 2017.

Senator ANDREWS. Madam Chairman, at this point could I ask a question?

Senator HAWKINS. Yes.

Senator ANDREWS. As a member of the Senate Budget Committee, this is intriguing, because you are using an interest rate that is totally different than the interest rate the White House uses. The President sent a message to those of us on the Budget Committee and he assumes in that fifth outyear that interest rates are going to be at 6.2 percent. Now, do you know something in the Department of Agriculture that the President does not know? Are these charts based on the administration's position, or are you doing a little bit of Alice in Wonderland looking glass logic and coming up with some strange figures that make these charts show them what you want them to show?

Mr. BELLUZZO. Senator, that is an excellent question. [Laughter.]

What this attempts to demonstrate is what happens under a simple continuation of the status quo.

Senator ANDREWS. But the administration says there is not going to be a simple continuation of the status quo.

Mr. BELLUZZO. Certainly.

Senator ANDREWS. Yet, you are saying the administration is wrong.

Mr. BELLUZZO. I am saying——

Senator ANDREWS. What you are telling the committee in public testimony is that Dave Stockman and the President of the United States are wrong and you are right. That is what you are saying as you go along with these charts. And I find that kind of interesting. We are going to go into a Budget Committee session tomorrow and get new information from the administration. Which part of the administration is accurate, I guess, Madam Chairman, is what we ought to be asking.

Senator Hawkins. We probably should ask Paul Volcker.

Senator Andrews. I do not know if he is part of the administration.

But you have got an Assistant Secretary here. Can you explain why you are deviating that far from the administration's figures?

Mr. Hunter. Senator, I do not think we are deviating at all. What we are providing you is a series of representations of various situations that might or might not occur in the future. I think it is extremely difficult, as you understand as well as I do, to predict what interest rates will be precisely in the future. In the administration's view for presentation for budget considerations, it is expected that the interest rates will drop. We have the capacity to make calculations in that same vein with various assumptions, and have done so.

Senator Andrews. But this chart does not show what is going to happen in those outyears for the next century, using the President's assumed interest rates.

Mr. Belluzzo. If I may respond.

Senator Hawkins. Does one of those lines show it?

Mr. Belluzzo. None of these lines show that. We have done analyses using the assumptions provided by the administration.

Senator Andrews. But those are not on your charts.

Mr. Belluzzo. They are demonstrated in exhibit 1 of Mr. Hunter's testimony.

There are a number of cases where the formula will work, where the formula will, in fact, result in——

Senator Andrews. The formula works if you use the administration's figures for outyear interest rates.

Mr. Belluzzo. We said that. We said it in our testimony.

Senator Andrews. I know. Then why give us these charts deviating from the administration's posture. Are we not loyal?

Mr. Belluzzo. I cannot speak to loyalty. All I can speak to is how we approach it from a proper analytical standpoint. If we are all willing to accept the inevitability of the interest rates that are projected by the administration, then, you are right, this is meaningless.

Senator Andrews. But you are not willing to accept the administration's projections?

Mr. Belluzzo. I am not in a position to accept or reject them. I am in a position to analyze how the Fund would work under the proposed legislation and under a wide variety of possible scenarios. Had the interest rates stayed at the same level that they were in 1973, when the 5 percent Fund rate was established, we would not have a problem today either. Our purpose was to find out if there was a reasonable number of situations where the Fund would be in trouble under this legislation, depending upon what happens in the future.

My crystal ball is not any better than anybody else's, sir.

Senator Hawkins. Please continue.

Mr. Belluzzo. Thank you.

The final line, the blue line, represents the case that Mr. Hunter touched on, which is what happens if we set the revolving fund rate at a level about 2 percent or so below the prevailing CBO rate, which, in this example, is 11 percent.

In that situation, as you can see, the net notes receivable vary slightly over the next several years, sometimes rising, sometimes settling. But the rates are high enough to permit full retirement of the $7.9 billion in long-term notes. The Fund does not require, as a prerequisite for existence, the refinancing of CBO's. In fact, after the bulk of the CBO's have been redeemed by 2020, the net assets of the Fund begin to rise very substantially. The Fund will have attained a true self-sufficiency, if you will. Again, this case is only presented as an example of another possible way to structure the Fund.

The second chart demonstrates what happens to the Revolving Fund rates under all three of these particular projections.

The orange line, again, represents what happens if there is no change at all in the legislation, the rates stay at 5 percent, and the assets of the Fund are tapped out by 2002.

The blue line shows a flat 9 percent interest rate.

The red line demonstrates what happens under S. 1300, as we have modeled it. What happens is there is a slight increase in interest rates over the first several years, the middle six level, the rates drop to the midfives for the next decade or so, and then begin to escalate very rapidly as the full impact of the two low rates take effect within the Fund. And, finally, when the Fund's assets are exhausted in 2017, the Revolving Fund rate will have reached essentially the same rate as the Government pays for its own borrowing.

We did not go beyond that particular date, but through a particular anomaly in the formula, at the point when Treasury would be appropriating money, or Congress would be appropriating money to keep the Fund going at the $1.1 billion level beyond the date when the assets are exhausted, the rates will begin to drop, even though appropriations will be needed on an annual basis.

Exhibit 1, again, which is attached to Mr. Hunter's testimony, provides detailed information on 16 different simulations that we ran—and, again, this is only 16 of the hundreds we have run—provides representative interest rates and amounts in CBO's outstanding at various points in time. Again, depending on different scenarios, what the interest rate structure will look like in the future.

You will note that amortizing certificates of beneficial ownership has virtually no impact on the speed with which the Fund becomes insolvent.

We have with us today hard copies of the printouts that we have used in preparing exhibit 1, if the subcommittee would like to have them.

These analyses present our best efforts at modeling what the fund's operations will look like under S. 1300. We must note that among the formulas clause is a vulnerability for manipulation and for just downright error.

On page 3 of the attachment to Mr. Hunter's testimony there is a description of how wide a range of rates could be rationally set, depending upon how poorly one estimates the future, or how consciously one attempts to manipulate the rate upward or downward. And, briefly, what that page 3 shows is that for the second half of 1984, given the same basic sets of numbers, the Administrator could set the Revolving Fund rate anywhere between 3.1 percent and, I think, 9 percent, depending upon what sets of assumptions the Administrator wanted to use.

If one of the purposes for including a specific formula in this legislation is to discourage administrative caprice, this particular formula fails in that regard, very badly.

In summary, section 6, first provides a formula for setting interest rates. It is based on a framework of trying to keep the rates as low as possible while still avoiding Revolving Fund insolvency.

Now, we are satisfied that the formula we have used in our simulations correctly reflects the concept and the intent of the section 6 language, because, among other things, the staff assured us almost a year ago, last May, when we first told them the formula would not work, under a large number of these economic scenarios, that the formula that we used was, in fact, the one they had intended.

These conclusions were further confirmed by the fact NRECA's own recent computer modeling of how the Fund would operate, uses the same formula. And, second, as a general rule, the formula fails to resolve the Revolving Fund self-sufficiency, even with long-term note forgiveness; even with CBO refinancing, simply because it fails to set the rates high enough to cover the principal and interest expenses of the Fund.

Thank you.

Mr. HUNTER. Let me conclude with my statement.

I think we are looking here at the real issue before us as far as funding and interest rates are concerned; and that is whether or not the indebtedness of the Revolving Fund should be forgiven, or whether the Revolving Fund is to meet its responsibilities.

It is a fair question; I do not criticize anyone for addressing either side of this question. The question is: Should Treasury bear the burden of the cost of the subsidy, of the support of these favorable interest rates? The question then becomes: Is it necessary? Is it advisable to keep interest rates abnormally low for the loans REA makes from its Revolving Fund?

This is a fair question. It is a fair position to be on either side of that question. It is a question for each person to determine; whether or not, in their minds, it is important enough for those rates to be kept that low; that it is so important that they would say to Treasury that we are going to put that type of burden upon the Treasury of the United States. It seems to me this is the issue.

The other parts of the bill are extremely complex. The bill deals with a lot of things that need to be dealt with.

Madam Chairman, we hope that we might be heard again one day because, as this goes along, I think it is going to need to be addressed further. And, certainly, we will be more than happy to try to answer any questions that we can.

Thank you for allowing us to be heard.

Senator HAWKINS. Thank you.

Senator Zorinsky has joined us. Do you have an opening statement?

Senator ZORINSKY. I did, Madam Chairman. Just let me read a couple paragraphs in the interest of time to make sure that others have an opportunity to testify, I will ask the chairman to enter my statement in the record.[1]

Senator **Hawkins**. Surely.

Senator **Zorinsky**. The REA Loan Program for these almost 50 years represent a significant Federal investment in rural America. The success of the Rural Electrification and Telephone Program in rural America, as well as in our other States provide ample evidence that this investment has paid large dividends, not only to rural America but to our cities and towns also.

It has been said that even if the REA Program had been a grants program, rather than a lending program, that the Federal investment would have been worthwhile. Not only did the REA Program bring rural America into the 20th century, in terms of helping ease the physical burdens for a lot of our farmers and their families before electricity, but the REA Loan Program played a large role in increasing the productivity of the American farmers in our rural communities.

The rural communities, obviously, are going to have to continue to seek some type of Government involvement in the future service, whether it be electrical, telephone, or whatever. You know, it really amazes me that we think nothing, when we talk of interstate highways, how would a million and a half people in Nebraska offset it with tax-generated capabilities to provide the hundreds of miles of interstate highway in Nebraska. Yet, Nebraska is proud to join all of those States that produce agriculture, producing not only the food for the Nation, but for a great deal of the rest of the world.

I think this should be an asset of the country that I think we jealously preserve, not fundamentally begin to tear down, as it appears is being done at this table. And it is even more unique when, at 2:30 this afternoon, as a member of the Foreign Relations Committee I have to go over there and debate the anxiousness of everybody around the table there in putting $8 to $9 billion in Central America, while I have to go back and tell the farmers of America, "You have got to pay your own way, but we are going to spend $8 or $9 billion someplace where we have no control."

Madam Chairman, I want to compliment you and thank you for holding these hearings. I think we have to do them in an expeditious manner inasmuch as the tremendous time in recesses we have taken this year leads me to believe that the difference between kindergarten and Congress is that Congress has more recesses. [Laughter.]

I would hope that we can conclude these hearings and go to an early markup in order to do those things that need to be done in advance of what we see coming down the road, down the road both from the administration's view and our view.

Senator **Hawkins**. Thank you.

Speaking of density——

Senator **Zorinsky**. Are you talking about me?

Senator **Hawkins**. No.

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[1] See p. 153 for the prepared statement of Senator Zorinsky.

Do you have the figures of what the average density is now of an REA electric cooperative versus telephone cooperative. I know what the standards were supposed to be.

Mr. HUNTER. I will have to ask some of my staff if someone has an answer for that.

Senator HAWKINS. What are the rules? What does the law say?

Mr. HUNTER. We do not have it at hand, Madam Chairman.

Senator HAWKINS. If I recall, it is one customer per 5 square miles of REA telephone service. I cannot recall if that has been changed.

Mr. NAYLOR. They continue to borrow, Madam Chairman.

Senator HAWKINS. Yes.

Mr. NAYLOR. In fact, we currently have a growing number of our REA co-ops that are essentially urban, and serve urban areas in some parts of the country. For example, Manassas is served by a cooperative electrical, and South Lake Tahoe, in California, is essentially an urban area served, as are some other areas in Nevada, and some of the other areas around the country. As population density has increased and urbanization has increased, there are a growing number of the cooperatives who do serve essentially urban areas that are still eligible to borrow.

Our concern, as Mr. Hunter has indicated in earlier testimony, is to focus our attention on those rural areas that, in fact, have very low density and will continue to need the assistance and support of REA to provide service at a reasonable cost, along with a number of other factors that we believe should be taken into consideration in determining where funds are made available.

Senator HAWKINS. Are REA rates lower than IOU's?

Mr. HUNTER. They vary. It is difficult to compare in that there are many IOU rates that are higher than the co-op rates. There are many of the co-op rates that are higher than the investor-owned.

One of the things which impact electrical rates, in particular, is that the cooperatives got into the business of building generating plants a little later than the investor-owned utilities. The investor-owned utilities have the benefit of cheaper power in many cases because they had built those generating plants at a time when the cost was considerably less than it is today.

Senator HAWKINS. Could you provide for the record a copy of the State-by-State of the average REA rates versus the IOU, investor-owned utilities?

Mr. HUNTER. We can do that for you, and will be glad to do so. Also, a considerable segment of those differentials are not substantive. We might show which ones are different by what percent.

[The following material was submitted by Mr. Hunter:]

RESIDENTIAL SERVICE—AVERAGES [1]

TABLE 8A.—STATE AVERAGE TYPICAL RESIDENTIAL BILLS, JAN. 1, 1983 AND JAN. 1, 1982

[In dollars]

State	250 kWh		500 kWh		750 kWh		1,000 kWh		2,500 kWh	
	1983	1982 [1]	1983	1982 [1]	1983	1982 [1]	1983	1982 [1]	1983	1982 [2]
Alabama	19.95	16.02	33.97	28.52	48.22	41.23	60.25	53.93	131.69	118.06
Alaska	17.95	17.43	30.91	29.70	44.11	41.22	56.67	52.99	132.48	123.54
Arizona	23.20	23.80	38.38	39.56	50.84	52.44	63.55	65.63	130.65	135.14
Arkansas	19.61	19.16	33.22	30.13	41.40	37.24	54.68	47.88	105.64	94.93
California	16.23	17.45	36.65	39.53	52.37	54.43	72.82	74.58	183.42	207.26
Colorado	18.41	17.04	33.31	30.86	48.15	44.25	63.00	58.02	148.58	139.90
Connecticut	27.55	27.68	48.60	48.84	67.32	66.11	88.30	86.99	196.10	208.12
Delaware	26.10	26.65	46.96	48.14	65.22	67.07	83.53	86.05	192.89	199.42
District of Columbia	13.46	14.06	28.04	27.79	39.65	36.69	54.23	50.42	131.15	117.56
Florida	20.78	20.62	36.43	36.40	51.66	52.17	69.08	69.29	171.10	172.09
Georgia	16.66	15.98	28.96	27.74	41.06	38.97	52.55	50.10	120.83	116.08
Hawaii	29.15	33.71	53.14	62.26	77.05	90.73	100.90	119.13	244.25	289.85
Idaho	9.41	6.88	17.83	13.16	26.68	20.20	35.63	27.70	90.48	80.05
Illinois	21.97	19.15	41.94	37.24	50.82	45.84	68.44	61.81	120.29	114.14
Indiana	20.10	18.12	34.96	31.36	47.35	42.72	60.08	54.40	129.80	117.21
Iowa	18.98	19.73	34.55	35.71	45.72	45.57	59.96	59.96	119.81	124.13
Kansas	19.67	18.19	35.05	32.23	48.92	44.66	63.73	57.99	140.18	127.87
Kentucky	15.46	14.87	27.76	26,58	38.14	36.36	49.16	46.79	110.63	105.20
Louisiana	17.91	15.73	31.86	28.22	44.34	38.82	57.73	50.72	135.37	117.90
Maine	17.51	17.31	34.95	33.71	52.37	49.76	69.81	65.81	174.29	162.04
Maryland	20.43	19.81	37.66	35.38	49.09	46.22	62.80	58.87	138.71	129.74
Massachusetts	24.34	23.76	44.38	43.69	60.31	57.33	80.03	75.79	189.21	178.52
Michigan	15.78	14.10	31.23	27.90	43.44	38.42	62.78	56.08	148.82	132.96
Minnesota	14.09	16.16	30.41	29.57	43.65	42.54	57.06	55.62	126.54	117.27
Mississippi	19.16	17.67	34.38	31.54	45.09	40.96	57.57	52.13	119.96	117.84
Missouri	18.09	16.96	32.28	30.22	43.39	40.60	56.00	52.37	105.08	98.29
Montana	11.95	9.84	21.38	17.69	30.90	25.61	40.42	33.53	98.73	81.98
Nebraska	17.93	16.05	29.78	26.43	39.64	35.27	49.71	44.30	98.47	87.01
Nevada	18.93	15.41	34.52	28.48	50.06	41.55	65.61	54.62	158.90	133.06
New Hampshire	22.66	23.15	46.92	41.72	62.01	56.22	84.25	74.74	203.22	183.09
New Jersey	28.51	27.31	50.37	47.53	68.25	64.00	89.08	83.19	209.60	194.26
New Mexico	20.46	21.01	38.18	39.30	54.33	56.47	71.29	74.36	170.36	178.19
New York	32.36	31.27	58.11	58.41	79.69	76.63	106.89	102.86	266.57	256.67
North Carolina	19.18	18.04	33.52	31.56	47.22	44.05	60.95	56.67	133.91	124.42
North Dakota	17.66	16.53	31.25	29.29	43.71	40.93	57.28	53.68	125.22	124.40
Ohio	21.19	19.27	39.52	34.93	57.02	50.06	71.90	63.03	148.14	130.47
Oklahoma	18.17	15.52	31.36	27.48	42.49	36.75	52.99	45.67	115.78	98.80
Oregon	9.84	8.91	17.53	15.66	25.73	22,89	34.71	30.83	94.48	83.62
Pennsylvania	23.03	21.26	40.91	39.05	53.29	52.28	71.05	70.00	149.40	148.15
Rhode Island	23.57	21.82	41.00	37.76	59.71	54.96	79.47	73.10	190.00	174.36
South Carolina	20.41	19.19	35.00	32.58	48.54	44.98	61.99	57.25	140.05	128.96
South Dakota	19.25	18.57	33.19	32.11	46.38	44.59	59.69	57.42	121.82	116.39
Tennessee	12.59	12.19	22.94	22.12	34.72	33.44	46.49	44.76	117.15	112.68
Texas	20.59	18.76	35.68	32.90	49.36	44.44	64.24	58.38	135.96	124.26
Utah	18.60	21.43	36.27	36.83	49.53	44.98	65.79	60.74	144.69	121.60
Vermont	16.47	15.32	38.90	35.82	50.39	46.63	73.40	67.74	205.86	189.38
Virginia	21.11	20.30	36.71	35.07	52.32	49.85	65.43	62.14	139.76	131.63
Washington	9.32	7.40	15.44	12.00	23.21	17.70	31.07	23.50	80.65	60.24
West Virginia	17.22	16.23	30.22	28.31	42.37	39.55	54.44	50.72	124.96	115.82
Wisconsin	18.13	15.92	33.09	28.81	43.76	37.33	58.68	50.18	147.27	126.28
Wyoming	13.50	10.90	23.12	19.23	32.34	27.32	42.00	35.64	96.31	86.46
United States	20.72	19.82	38.35	36.96	52.74	50.07	69.96	66.39	160.22	155.69

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[1] Includes data reported by privately owned and publicly owned utilities.
[2] Revised figures based on 1980 census population.

Source: Energy Information Administration Form 213.

REA BORROWERS—STATE AVERAGE RESIDENTIAL BILLS AND RANK OF STATES FROM LOW TO HIGH AS OF JAN. 1, 1983

	BILLS					RANK				
	250 kWh	500 kWh	750 kWh	1,000 kWh	2,500 kWh	250 kWh	500 kWh	750 kWh	1,000 kWh	2,500 kWh
United States	21.58	36.68	51.33	65.80	149.32					
Alabama	19.87	34.95	49.80	64.49	150.77	12	14	17	20	25
Alaska	31.09	50.62	69.56	86.06	194.25	45	45	45	42	41
Arizona	24.18	41.61	58.34	75.52	176.43	39	35	35	36	36
Arkansas	23.43	37.57	50.41	62.97	132.66	33	26	19	18	14
California	19.04	32.44	46.80	61.10	139.27	10	9	12	13	18
Colorado	21.25	37.54	53.45	69.28	163.89	18	25	28	30	34
Connecticut										
Delaware										
Florida	25.13	43.83	62.52	81.22	193.40	40	41	41	40	40
Georgia	21.01	34.89	48.44	61.41	134.02	15	13	15	15	15
Hawaii										
Idaho	18.16	26.91	35.67	44.42	98.11	5	5	3	3	3
Illinois	25.86	43.21	58.77	74.05	155.58	41	33	36	35	28
Indiana	22.01	36.98	51.42	65.45	144.94	24	22	23	22	21
Iowa	27.40	43.41	57.66	71.02	147.64	43	40	34	33	23
Kansas	21.13	36.88	52.24	68.89	159.27	15	20	26	29	31
Kentucky	18.99	33.05	46.39	59.65	136.85	9	12	11	11	17
Louisiana	22.95	42.06	61.13	80.08	181.72	29	38	39	39	37
Maine	26.93	48.88	69.31	89.27	211.80	42	44	44	45	44
Maryland	23.40	41.49	59.58	77.67	186.20	32	34	37	38	39
Massachusetts										
Michigan	23.85	41.93	59.65	77.31	183.11	37	37	38	37	38
Minnesota	23.70	40.44	56.90	73.35	168.51	36	33	33	34	35
Mississippi	18.59	32.59	46.35	59.03	139.86	8	10	10	12	19
Missouri	22.29	35.28	47.25	58.89	124.13	25	17	13	10	10
Montana	15.35	24.78	34.01	43.06	96.63	2	1	2	2	2
Nebraska	24.11	37.84	49.91	61.84	128.04	38	26	18	16	11
Nevada	19.21	30.21	41.22	51.93	115.81	11	8	8	8	7
New Hampshire	22.56	46.18	66.56	88.23	220.38	27	42	42	44	45
New Jersey	28.05	48.08	68.13	88.16	208.40	44	43	43	43	43
New Mexico	21.97	38.47	53.87	68.80	160.79	23	29	30	28	33
New York	16.12	26.34	36.57	46.80	108.16	3	4	4	5	5
North Carolina	21.49	36.70	51.82	66.36	150.01	21	19	24	24	24
North Dakota	21.22	34.95	48.14	61.19	129.09	17	15	14	14	12
Ohio	22.69	38.84	54.43	69.86	159.09	28	31	31	32	30
Oklahoma	21.27	37.26	52.61	68.42	160.02	19	23	27	26	32
Oregon	18.34	28.64	38.88	49.11	110.65	7	7	7	6	6
Pennsylvania	23.47	37.77	51.33	66.01	146.16	34	27	22	23	22
Rhode Island										
South Carolina	20.58	35.04	40.33	63.58	144.90	13	16	16	19	20
South Dakota	22.99	37.41	50.93	64.83	132.44	30	24	21	21	13
Tennessee	14.32	25.92	37.94	49.32	121.38	1	3	6	7	8
Texas	21.52	36.98	52.11	67.02	154.28	22	21	25	25	26
Utah	17.19	27.11	36.84	46.48	104.32	5	6	5	4	4
Vermont	21.32	41.69	62.05	82.44	203.66	20	36	40	41	42
Virginia	23.69	39.60	54.90	69.69	154.95	35	32	32	31	27
Washington	16.87	25.24	33.82	42.15	92.69	4	2	1	1	1
West Virginia	22.52	36.59	50.66	62.75	135.30	26	18	20	17	16
Wisconsin	23.31	38.76	53.68	68.71	156.76	31	30	29	27	29
Wyoming	20.74	32.84	44.53	56.32	123.88	14	11	9	9	9
Puerto Rico										
Virgin Islands										

Senator HAWKINS. Does REA have a copy of the settlement contracts between the REA telephone companies and the longline companies?

Mr. HUNTER. Do you mean the current ones that we are moving into at the present time?

Senator HAWKINS. The ones they have had.

Mr. HUNTER. The ones they have had, I believe we have copies of those. If we do not have, we can provide them to you.

Senator HAWKINS. Would you provide that also?

Mr. HUNTER. Yes, we will.

Madam Chairman, in regard to the question of urbanization and change in the profile of our borrowers' districts, this, again, is one of the things we did not touch on because of the brevity of time involved. But S. 1300 also restricts REA from making any targeting or change in our ratios and criteria, unless we have an increased program, which brings our electric program from 850 million up to a billion-dollar program. And we feel that the agency really ought to address indexing or targeting our support to where the needs are the greatest, because the profile of our borrowers has changed very substantially in recent years.

Senator HAWKINS. Take for example, where a company started with the rural classification, such as Fort Myers, FL, the fastest growing county in the United States; as an REA electric company, Lee County Co-op, has 80,000 subscribers and the meter reader walks from house to house. This cooperative no longer serves a primarily rural constituency. Maybe we should address that.

I want to ensure that rural areas have the telephone and electric services of the city, but, at some point in time, it seems, if the population changes, they should be weaned off Federal money and compete on their own.

Mr. HUNTER. Or at least that support from REA should be graduated.

Senator HAWKINS. I agree.

Senator Andrews, do you have any questions? I know you are also to be in several different meetings.

Senator ANDREWS. Well, we are here because this is pretty important, not just for rural America, Madam Chairman, but the economy as a whole.

I am glad you brought up the point of density. As the author of the density formula, when we put that bill together 11 years ago, let me say that it represented, again, the good faith sensitivity of the rural electric co-ops themselves. Because they said, "We know that some of our cooperatives have now become, in essence, as you point out, urban operations; that the meter reader walks from meter to meter." And that is why we put the formula of density in, so that those low density, those that have less than two consumers per mile of line stayed with the lower interest rate; not to give them a subsidy, but to give them comparably priced electric rates. Comparability is the key thing.

You asked a couple of questions of Mr. Hunter. I would like to ask one more along that line, to follow up.

Is it not true, Mr. Administrator, that rural electric co-ops consistently have to charge more, or consistently do have to charge more for electricity than investor-owned utilities in the same area?

You cannot compare apples with oranges and say that you are comparing an IOU in the Eastern part of the country with a rural electric co-op in the West. But, in a given area, is it not rather consistent that the rural electric co-op has to charge more for electricity than the investor-owned utilities?

Mr. **Hunter**. That varies from area to area. But, Senator, you are correct in that more co-ops have to charge more than do the investor-owned utilities.

Senator **Andrews**. In the same area which takes out the unequal factor of differing power charges, which can vary from State-to-State and area-to-area

Mr. **Hunter**. It does to some degree, except the investor-owned utilities, again, have the advantage of having opportunity to purchase from generating plants that were built earlier and, thereby, their costs are normally less for the cost of wholesale power.

Senator **Andrews**. But, in other words, given attention to density that is put in the act, has, in fact, been working, but is still needed because we still have higher costs of electricity in rural electric co-ops than we do in the investor-owned utilities, which shows that there is a need for density.

Mr. **Hunter**. Senator, I would agree with you. The proposals we have thought of, worked on and deliberated within REA which address the idea of targeting, have certainly taken into consideration density. We felt that density is a prime factor for consideration in such a plan.

Senator **Andrews**. Mr. Naylor mentioned a moment ago, as I understood it, and maybe I was hoping rather than listening accurately, that he still saluted the concept of density and would work to make sure that those low density co-ops got more favorable rates from the loans that they had so that they could maintain comparability rates. Is this what I heard you, in essence, say?

Mr. **Naylor**. Senator, we continue to feel that attention does need to be given to density. That as far as providing funds are concerned for all categories of lending in the REA, density, along with a number of other related factors, as Mr. Hunter has mentioned, continues to be very important. We need to, as you indicated here, take a hard look at those areas whose characteristics have changed dramatically and what their continued use of the fund ought to be, and whether there should not properly be an appropriate adjustment.

Senator **Andrews**. But for those low density co-ops, you intend to support a continuation of funding at a lower interest rate in order to get comparability costs in electric service?

Mr. **Naylor**. We continue to support targeting funds into that area and, certainly, depending upon the structure of the legislation that is in effect, depending on what that interest rate structure might be, make that——

Senator **Andrews**. The legislation that is in effect now is 2-percent interest rate.

Mr. **Naylor**. Well, it is 2 and 5.

Senator **Andrews**. Two for low density.

Mr. **Naylor**. But we, I think, Senator, clearly have to look at the entire interest rate structure question that is in this proposal S. 1300. It has been looked at in a proposal that was offered in the

House. The administration is developing its own proposal, and has not yet submitted its own legislation. But the interest rate base structure is going to have to be addressed in each of those cases, and in each case, I think some upward adjustment is expected and anticipated.

Senator ANDREWS. Well, during your testimony, you, in a sense, interpreted the will of Congress, or the intent of Congress, or as we call it, congressional intent. You said that the reason we set the interest rate at 5 percent was logical because the Treasury rate was then at 6 percent. You were not there. Let me assure you, from the standpoint of those of us who wrote the bill, we didn't set that 5-percent rate because interest rates happened to be in that area. We did not set the 2-percent rate because interest rates happened to be in that area. The total discussion in putting that bill together was based on comparability to the consumer out there. We set the rate that we felt was necessary to make sure that the rural family did not have one more incentive on their back to force them to move into the city, where it would cost the Federal Government a whale of a lot more to take care of them in housing and one thing or another than if you could encourage them to stay on the land. Those are the rural families, obviously, who have retired or who are not living on a farm that they are farming.

In the Eisenhower administration—not the Eisenhower administration, the Nixon administration, the Republican administration at that point in time saluted the concept by setting up a Rural Development Section of the Department of Agriculture. A friend of mine by the name of Will Erwin was heading that up. Bob Bergland and I were in the House at that time, and they came up and said it is extremely important to develop the rural areas so we will incentivize people staying in the small towns, staying in the rural area through comparably priced telephone service, comparably priced electric service, low-interest housing loans, and a whole host of things we put together.

Is the administration abandoning that incentive that was put in more than a decade ago? Are you moving away from that concept of comparability of rate structure?

Mr. NAYLOR. Senator, I think in the entire Federal lending area of activity, we are moving toward interest rates that more accurately reflect the cost of money to Government. That has been universally the case in all of the various Federal lending programs which have gone almost unchecked, out of control over the last decade or so, and represent a substantial burden on the national debt today. And also, a burden on the ability of the private sector, including individuals, to get mortgage money, to be able to access funds and to generate the kind of economic recovery that we know we need and are trying to achieve.

The answer to your question is yes, we are moving toward interest rates that more accurately reflect the cost of money to Government and are more comparable.

Senator ANDREWS. So you are moving away from the concept of rural development, the incentives that would allow families to stay in rural areas, and you are moving then toward a strictly dollar-for-dollar type thing that, in effect, would denude the land and move more and more families into the city.

Mr. NAYLOR. No, absolutely not, Senator.

Senator ANDREWS. How are you going to do that if you do not keep comparable costs of electricity, telephone service, housing, and the rest in rural areas?

Mr. NAYLOR. Senator, I think you will find there are many factors other than the cost of money involved in the ability to maintain reasonable rates, including a wide range of managerial and construction decisions.

To make it appear as though it is entirely a question of what you can borrow money at would be very misleading. Certainly we continue to support the development of rural America very strongly, the development of new nonagricultural employment opportunities, along with the agricultural base, out in rural America. There is a substantial interest on the part of the private sector to be involved in that, as there is by the Farm Credit System, among others, the commercial bankers.

There is not a shortage of credit available. The credit is certainly there. The interest is there. It is important that the infrastructure be there. We have had to provide that and will continue to do so. We support very strongly the Rural Electric Administration and its role, particularly in less dense areas, that it is going to be there and be there for some time into the future, as are a number of other programs that continue to be in effect.

Senator ANDREWS. There is an availability of funds only at an unaffordable rate. And the point I am trying to make, the comparability of cost is the important thing in rural development, or sustaining the rural culture that is there.

But, to get on another subject: Is there a need for more funds? Are the rural electrics making more applications for loans than you are processing? Do you have a backlog of applications, or is there adequate funding for the GNT's, and for the transmission co-ops?

Mr. NAYLOR. We currently do not have a backlog. And, as we testified yesterday before the House Appropriations Committee, the current applications on hand for both categories of credit are less than the budget request we have before Congress at this time.

Senator ANDREWS. Have you done anything to incentivize the building of more generating plants in order to move more toward energy independence?

Mr. NAYLOR. Senator, I think we are going to have to look very carefully at areas where we perhaps have excess capacity, and areas which genuinely need capacity. I think management decisions in determing whether new plants should be started and the relative costs of other sources of power that may be available, are going to have to be examined very closely, certainly as we look at some 17 nuclear plants we are involved in. We are very concerned that those plants be successfully completed, or that we find ways to cope with the huge expense of those that are not completed.

Senator ANDREWS. But to incentivize the use of American energy is a key thing. I am about to have to go back to another subcommittee, the Defense Subcommittee, where the administration is asking us for $23 billion for rapid deployment; $23 billion for a new force structure to project our military presence in the Middle East. And when we ask why, the answer we get back from the four-star generals and Assistant Secretaries of Defense is, "We have to keep our hands on that energy over in that part of the world."

In other words, the administration is asking for $23 billion to try to keep our military hands this next year on energy that is not ours. It would seem logical, then, that we would make some kind of investment and some major effort in trying to become more energy independent.

Have you, in view of that goal of the administration, gone out and incentivized or encouraged, or whatever words you want to use, our local rural electric distribution co-ops to encourage their farmer members to switch from burning oil, which has to be imported, to heating their homes with electricity? These are homes that are not near a gasline. What have you done to encourage the use of domestically produced energy? There is a lot of the energy coming from coal; of course, some is nuclear, but, mainly, it is coal, so that we can get off of this terrible drag on the economy of having to import 35 percent of our energy in the form of, largely, oil from those wonderfully stable friends of ours, Iran, Iraq, Lybia, and the rest. What have you been doing to follow up this energy independence concept, Mr. Secretary?

Mr. **NAYLOR**. Senator, we have not engaged in any specific promotional program, such as you address, nor do I think it appropriate that we would do so.

Senator **ANDREWS**. Would it not be wise?

Mr. **NAYLOR**. Senator, I think, from a consumer perspective, looking at some of the costs of proposed new plants, particularly if they involved building excess capacity for which the consumer then has to pay at least some of that cost until that power is really necessary, no, I am not sure that it is the best for producers that are already financially strapped.

Senator **ANDREWS**. I am not talking about excess capacity. I am talking about capacity that can be utilized.

Mr. **NAYLOR**. Well, there is capacity that can be utilized. In most parts of the country today, there is more than adequate capacity available.

Senator **ANDREWS**. Would this not be a good way to stimulate the use of more domestically produced energy and make us less dependent on imported energy?

Mr. **NAYLOR**. I would presume, Senator, that the distribution cooperatives and their giant G&T's would promote the use of the capacity that they have. Certainly they do not want to sit on capacity that is not being utilized.

Senator **ANDREWS**. But you are not encouraging, from the administration level, this innovative concept that could follow through on our need for energy independence?

Mr. **NAYLOR**. No, we are not engaging in public relations, for which the Government is often criticized for doing. No, we are not engaged in that type of promotional activity and, frankly, we have been quite criticized historically in the Congress for times when we have done that, or been perceived as having done that in the past. I would not expect that we would do so at this time.

Senator **ANDREWS**. One final question, Madam Chairman.

Again, going back to the charts. How can the administration come up before us and use one set of figures to talk about what the growth needs are in the Defense budget and use an interest rate, an assumed interest rate, that justifies those kinds of expenditures even with our huge outyear deficits; and then another arm of the same administration comes in and shows us a set of charts going past the year 2000 that uses interest rates almost precisely double? Does that mean that you use one interest rate when it suits your fashion better than the other interest rate does, or that you are trying to con the committee, or that you thought we would not ask the question "are you consistent with your interest rates?" How do you justify that?

Mr. NAYLOR. Senator, I would have been disappointed if you had not asked that question. Obviously, predicting the future is a less than fine art by any set of conditions. Our ability to predict what interest rates will be under various future administrations and various future economic conditions is extremely difficult. We certainly hope that the expectations represented in the budget presentation by the administration on the broad future of the economy are accurate. But, as business people, looking at various options is a sound business approach. It would not be responsible for us not to consider the full range of scenarios that might develop in the future. We have prepared these using a wide range of interest rates, and a wide range of possible scenarios, trying to determine, under any conditions, or any future administrations, what the long-term future of this fund will be. And we have tried to do that in a responsible and businesslike fashion. It in no way undermines the hope and assumptions that were presented on the part of the administration in a general way.

Senator ANDREWS. But, let us be perfectly frank about it. I think that your assumptions about the interest rates are a whale of a lot more accurate than theirs. The thing is I had being ying-yanged around by an administration that says one thing when they want to make a point for a program they favor and uses another set of interest rates when they want to make a point against a program that they do not happen to go along with. And that is the reason I wanted to bring up the point, and I appreciate the totally flatout honest testimony that you gave us that said, "if we used the administration's"—and I think this is important, Madam Chairman—

> That if we used the administration's assumption of outyear interest rates, this program, this bill we are discussing today in this committee, would be eminently workable and would, as a matter of fact, have trend lines totally different than the charts that are shown the committee.

But, do you have—just one final question—do you have a better suggestion than this legislation that we put together?

Mr. NAYLOR. Senator, the administration is developing and, frankly, we have not completed our internal work on it, a legislative proposal. There are alternatives that have been considered, which could be considered and I would hope, perhaps, would be considered.

Senator ANDREWS. Yet, you do not have an alternative at this time?

Mr. NAYLOR. We do not have a proposal for consideration today. We do expect to have one.

Senator ANDREWS. Thank you, Madam Chairman.

Senator **Hawkins**. Thank you. I recently returned from meetings with the Canadian Government. I'm curious—could you tell me if any of the REA's purchase power from Canada?

Mr. **Hunter**. Yes, they do. Let me make sure I am answering you correctly.

[Mr. Hunter conferring privately with staff.]

Mr. **Hunter**. I think it is a limited amount. This issue concerns some of our borrowers in the northern part of the United States because there is power up there, but the capability to move it is somewhat limited yet, as far as transmission lines are concerned.

Senator **Hawkins**. Canada has a great surplus and has entered into quite a few contracts with IOU's in California, the State of Washington, and others—all hydropower.

Mr. **Hunter**. The advantage is that it is based on hydropower, and it is quite a bit cheaper. We need to remember that one of the things that concerns our own generating capability is that there is a surplus here. We have plants here that have more generating capability than they have a market for at the present time. That, again, is compounding the cost problem for our users at the end of the line. That generator capability, even though it is not being used, still has to be paid for because of the investment in it and because the plant does exist. This comes right back to the thing that Mr. Naylor was speaking about. Probably the greatest concern we have is—how we are going to deal with the construction cost of some of the plants that are now being constructed.

Senator **Hawkins**. How many plants are under construction?

Mr. **Hunter**. There are 17 nuclear plants that we have some interest in under construction, which is the greatest concern.

Senator **Hawkins**. How many oil?

Mr. **Hunter**. We do not have it specifically, but we will provide that.

Senator **Hawkins**. Would you also please provide the location?

Mr. **Hunter**. We will do that.

[The following material was submitted by Mr. Hunter:]

PLANTS UNDER CONSTRUCTION WITH REA FINANCING (AS OF MAY 31, 1984)

[Oil/Gas: There are no units under construction which use either oil or gas as a fuel.]

Borrower	Plant	Location	Capacity	Remarks
COAL				
KAMO Electric Cooperative	G.R.D.A. 2[1]	Shouteau, OK	200 MW share.	
Arkansas Electric Cooperative	Independence 2[1].	Newark, AR	245 MW share.	
Colorado-Ute Electric Association	Craig 3	Craig, CO	447 MW	
Seminole Electric Cooperative	Seminole 2	Palatka, FL	600 MW	
Oglethorpe Power Corp	Scherer 2[1]	Monroe County, GA.	485 MW share.	
East Kentucky Power Cooperative	Smith 1	Clark County, KY.	600 MW	Smith 1 construction delayed for further study.
Big Rivers Electric Corp	Wilson 1 and 2.	Centertown, KY.	2–400 MW	Wilson 2 construction delayed for further study.
Plains Electric Generation & Transmission Cooperative.	Escalante 1	Prewitt, NM	215 MW	

PLANTS UNDER CONSTRUCTION WITH REA FINANCING (AS OF MAY 31, 1984)—Continued

[Oil/Gas: There are no units under construction which use either oil or gas as a fuel.]

Borrower	Plant	Location	Capacity	Remarks
COAL				
Cajun Electric Power Cooperative	Oxbow 1[2]	Armistead, LA.	540 MW	Oxbow 1 construction delayed for further study.
Basin Electric Power Cooperative	Antelope Valley 1 and 2[2].	Beulah, ND	2–435 MW	
Deseret Generation & Transmission Cooperative	Bonanza 1	Bonanza, UT	400 MW	
HYDRO				
French Broad Membership Corp	Capitola	Marshall, NC	3 MW	
Washington Electric Cooperative	Wrightsville	Middlesex, VT.	1 MW	
Vermont Electric Generation & Transmission Cooperative.	North Hartland.	North Hartland, VT.	4 MW	
NUCLEAR [3]				
Oglethorpe Power Corp	Vogtle 1 and 2.	Waynesboro, GA.	690 MW share.	
Soyland Power Cooperative	Clinton	Clinton, IL	100 MW share.	
Western Illinois Power Cooperative	do	do	90 MW share.	
Wabash Valley Power Association	Marble Hill 1 and 2.	Jefferson County, IN.	384 MW share.	Construction has been terminated by Company. WVPA studying its alternatives.
Kansas Electric Power Cooperative	Wolf Creek	Burlington, KS.	69 MW share.	
Cajun Electric Power Cooperative	River Bend	St. Francisville, LA.	280 MW share.	
Wolverine Power Supply Cooperative	Fermi 2	Monroe County, MI.	220 MW share.	
South Mississippi Electric Power Association	Grand Gulf 1 and 2.	Port Gibson, South MS.	250 MW share.	Unit 2 on "hold".
New Hampshire Electric	Seabrook 1 and 2.	Strafford County, NH.	50 MW share.	Company has announced possible cancellation of Unit 2.
North Carolina Electrice Membership Corp	Catawba 1	Charlotte, NC	644 MW share.	
Saluda River Electric Cooperative	Catawba 1	Charlotte, NC	215 MW share.	
Allegheny Electric Cooperative	Susquehanna 2.	Berwick, PA	105 MW share.	
Brazos Electric Power Cooperative	Comanche Peak 1 and 2.	Glen Rose, TX.	87 MW share.	
Tex-La Electric Cooperative	do	do	50 MW share.	
Vermont Electric Generation & Transmission Cooperative.	Seabrook 1 and 2.	Strafford County, NH.	9.5 NW share.	Company has announced possible cancellation of Unit 2.
	Millstone 3	Waterford, CT.	4 MW share.	

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[1] Participation in shared units.
[2] Fuel is lignite.
[3] All cooperatives involved in nuclear plants are participants in shared ownership.

Senator HAWKINS. How much would S. 1300 cost the Treasury? Did you state that in your testimony?

Mr. HUNTER. Our feeling, based on certain assumptions, is that it will cost the Treasury somewhere between $19 and $21 billion over the life of the loans and the indebtednesses that are referred to within the bill.

Senator HAWKINS. Under this bill, or any of the proposals that raise interest rates, how does that impact the consumer's bill?

Mr. HUNTER. It does impact the consumer's bill, but it impacts it in a minimum way. The area of discussion we were just on touched the area that impacts it the most, and that is the cost of wholesale power. The cost of wholesale power amounts to from 65, to, in some cases, as much as 80 percent of the overall cost of operation of the distribution co-op. The cost of paying interest, which is the issue that we are discussing here, in a distribution co-op, amounts to about 4.4 percent, on a national average, of the total cost of operation which, again, converts into that user's rate. So it is a minimal impact. It escalates very slowly.

Senator HAWKINS. Do you believe there is a better method to resolve the financial problems of the Fund, other than S. 1300?

Mr. HUNTER. We believe there are other approaches that would have more logic. Our feeling was that we needed to analyze to the best of our ability and to share with you the knowledge that we gained from this analysis as to the impact of S. 1300. This is our purpose here this morning. We do feel that there are other approaches that would be better.

Senator HAWKINS. One of the suggestions that has been around for a long time is to bring this activity back on budget. Are there any advantages or disadvantages, from your viewpoint, to do this?

Mr. HUNTER. In the wide range of consideration and concepts, the very idea of having expenditures and costs covered by the Federal Government on budget helps to make it very plain to those who are in the decisionmaking process what those costs are. So we feel there is good reason for the expenditures of Government being on budget, and REA is an expenditure of Government.

Senator HAWKINS. Senator Andrews spoke of the 1973 REA Act, which encouraged the development of resources and abilities to achieve financial strength needed to satisfy the credit needs from non-Federal sources. What success has been achieved and what do you think is the best measure of financial independence?

Mr. HUNTER. There are several measures of financial independence. Of course, the development of equity is one. If a co-op has a strong equity position, it reflects good management. It sometimes can reflect, of course, in a negative way the difficulties of the environment in which it operates. So those things have to be measured.

One of the things that is a good measure in some cases, or at least impacts the capability to be independent, is whether or not the user rate is comparable to those in the adjoining areas, and also across the Nation. If a user is not, you might say, paying as much as another co-op member is paying somewhere else, it might be that he is getting a greater advantage than that other co-op member.

Senator HAWKINS. Current law treats all borrowers the same by requiring the 70-to-30 ratio of Federal non-Federal funding sources. Are there not certain characteristics among the individual co-ops which are significantly different, such as retail rate, financial strength and the urban or rural nature of the co-op?

Mr. **Hunter**. There are, and you touched on one awhile ago when you spoke about the hydropower that might be available in Canada. If a co-op has access to relatively cheap wholesale power costs, that bulk power at a cheaper rate is a great advantage. If it so happens that co-op is in an economically depressed area, that impacts the ability to raise revenue.

Again, density becomes important. So there are many measures we feel should be taken into consideration. The legislative history written into the committee reports, and the language used in 1973, when the revolving fund was established, also addresses the thought that, as these co-ops develop capability and become stronger entities in their own right, they should be encouraged to use greater amounts of non-REA funding. And, yet, for a great number of years now we have continued to use a 70-to-30 ratio for all, regardless of capability, except in the case of discretionary loans, which are a relatively small number of loans.

Senator **Hawkins**. Do you have some other questions, Senator Huddleston?

Senator **Huddleston**. Thank you.

Just to pursue a little further what has already been touched on, I think, looking at your testimony very briefly, you indicated that you had been crying in the wilderness, so to speak, for some time that something needed to be done about the Revolving Fund. Several organizations that are interested in the Fund have been working to help develop the legislation that we are considering today, and have been working for about 2 years on this proposal. The bill itself was introduced last May. It has already been passed by the House. It seems to me a little strange that we do not have some specific legislative proposals from the administration yet, to deal with this problem. What you have submitted in the budget, is that the administration's solution to the problem? Or, will the administration send up legislation?

Mr. **Naylor**. Senator, we have dealt with it in part in the submission of the budget. And we have indicated in that submission that the administration is preparing legislation which would be consistent with our other Federal credit policies. It is in the final stages of preparation now.

We have also, as I think Mr. Hunter commented, worked very closely and tried to make our resources available. As indicated, we discussed the formula with NRECA a year ago and other related problems. We, frankly, were a bit surprised with this particular approach, because it reflects certainly, a very costly approach and, perhaps, in our view, the most costly approach. It is our view——

Senator **Huddleston**. I do not believe, even under the estimates that you are making, that you can characterize this as a very costly approach.

Mr. **Naylor**. Well, Senator, I understand that we can characterize these in a number of different ways, and I respect those options The administration and others in the financial community, even within the various budget authorities, have looked at the bill very closely. It is our assessment that we are looking somewhere between $19 to $21 billion of ultimate cost to the taxpayers at a time we are trying to cope with very substantial deficits.

There are alternatives that can be considered, in fact, were considered in the House, and we are trying to look at how some of those options might be best applied from the perspective of what the administration may propose.

Senator **Huddleston**. If we succeed in making certain that the interest expense will not exceed the interest income, as is the intent of S. 1300, and with the added assurance of an amendment such as the Stenholm amendment in the House, what effect do you think that would have on the Revolving Fund?

Mr. **Naylor**. Senator, I do not think any of the proposals I have seen added on to S. 1300 or H.R. 3050 on the House side have materially changed the expected cost on it. I think it needs to be reviewed. We are not unwilling to sit down and discuss the options that may be presented or considered during the course of your deliberations. But we strongly feel that this particular proposal, in its present form, simply is far too costly and does not solve the problem. There are better solutions we should consider before we take legislative action. And, while action is needed, it is not needed so urgently that we can not thoroughly examine the options available to us and what is most appropriate.

Senator **Huddleston**. Do you know when we might have the benefit of the administration's proposal?

Mr. **Naylor**. Senator, I would expect rather shortly. We are trying to complete the reviews internally on the proposal. We have indicated some aspects of it in the budget proposal before Congress now. Our concern is to move all Federal credit toward more realistic rates and impact on the total Federal operations. And we are trying to complete the details on that. We will try to submit it as quickly as possible.

Senator **Huddleston**. Now, the Congressional Budget Office indicates that the conversion of the $7.9 billion Treasury notes into equity of the Revolving Fund would have no effect on the budget deficits. Do you agree with that?

Mr. **Naylor**. I would hope that the committee would review very carefully later determinations made by the Congressional Budget Office and also by another resource of information available to you, that is the GAO, the Government Accounting Office. Both the GAO and the Congressional Budget Office have updated their figures by further studies, and I hope that you add those into your testimony. You will find that they support very strongly the positions we ascertained earlier. In the latest information we have from them, it indicates they are seeing the figures——

Senator **Huddleston**. Talking about bookkeeping and actual loss to the Government, what is going to happen if you have to bail out—really bail out—the fund? What if that curve takes that downward turn that looks like it is expected to do in a short time?

Mr. **Hunter**. Senator, this, I think, is the real issue we have here. And, in all due respect to how we may want to approach this problem, it is our opinion that we should address an interest rate which is more adequate to meet the responsibilities of the Fund, and that if we do, it would not have a substantially adverse effect upon the user at the end of the line. So we feel that the utilization of somewhere in the neighborhood of $20 billion in negative impact upon the Treasury is not necessary, not advisable at this time. It is merely a judgment call as to whether or not——

Senator HUDDLESTON. I think you have already heard from members of the committee the considerable concern about the Revolving Fund and the effect higher interest rates charged to borrowers will have on the users at the end of the line.

Just to followup some on what Senator Hawkins was asking about the utility rates, I have a document here on Rural Electrification Administration stationery. It indicates 68.7 percent of the consumers served by REA borrowers already have rates higher than consumers served by comparable electric utilities. In addition, we are talking about the infrastructure in rural areas and recent reports we have seen do not give us much encouragement as to what is being done to make sure that rural America has a viable economy, and can provide development and jobs.

Now, utilities are one of the real basics of that infrastructure. If you are going to attract industry or achieve a standard of living that is comparable to urban areas, the utility rates have got to be competitive, to say the least. So, it seems to me, this is an area of legitimate concern as to whether or not we are going to continue to make rural America a livable place, and encourage growth in industry and other business activities to provide for a better life in rural areas.

This bill, of course, is, essentially, attempting to continue the development of rural America and to meet the needs of those facilities already there. And, of course, the need does not go away once the facility is built. There is still development, maintenance, and all kinds of operating costs involved that are expensive in rural areas.

I think, as Senator Andrews was trying to indicate, I believe we need to keep in mind the original intent of Congress in establishing REA, and not take the position that all the goals have been accomplished or that we have reached a millenium, and finally arrived at the plateau where no additional help may be required.

I understand that one of the administration's policy objectives, is to bring about a greater reliance on commercial credit sources for REA borrowers. In view of that objective, does the administration support the provision in this bill mandating lien accommodation so that borrowers can obtain credit from commercial lenders when borrowers can demonstrate ability to repay?

Mr. NAYLOR. Senator, we do favor lien accommodations and are moving administratively to make additional adjustments available. We cannot support the provision in this bill, however, that places the Administrator in a position of, effectively, mandating him to make accommodations that may be fiscally unsound.

We would hope that a more moderate approach, with more discretion to the Administrator would be sought, much along the lines we are following administratively now to provide for a broader base of accommodation.

Senator HUDDLESTON. Do you agree that this bill still gives the Federal Government complete control over the Revolving Fund?

Mr. NAYLOR. Not to that degree. It is more restrictive in many ways. The Administrator currently has discretion and particularly under certain provisions of the bill than what we currently have.

In fact, if we did not maintain program level, we do not have discretion to make adjustments, for example, for the urbanization of certain areas as opposed to the more rural areas, that you have as much interest in as I do.

We think, if anything, more discretion is needed for the Administrator to adjust availability of funds; to target funds into areas legitimately because of density; because of available power costs, because of a number of factors, and need of REA-type assistance, as opposed to those who have a capacity to get commercial lending and are doing so quite effectively. We are increasingly seeing a broadened interest by the commercial sector. They are planning to increase the level, and have the capacity to do so.

Senator **Huddleston**. Madam Chairman, I yield at this time.

Senator **Hawkins**. Senator Zorinsky.

Senator **Zorinsky**. Thank you, Madam Chairman.

Could you tell me that has been the amount of REA loans made at the special interest rate during the past few years?

Mr. **Hunter**. Again, I will ask for staff to give me a more precise figure than I could give, Senator.

[Conferring privately with staff.]

Mr. **Hunter**. Slightly over $2 million in 2-percent loans.

Senator **Zorinsky**. What were the circumstances in the instances that you exercised your discretionary authority to make special interest rate loans?

Mr. **Hunter**. Some of these were cases where there had been extreme losses from storms, such as ice storms, with perhaps damage to the plant. Some of them were very isolated situations like we have in the Alaskan villages. Those types of activities where the costs are extremely high and the economic condition of the user is very low. These are the types of situations we approach, those situations where it is an extremely difficult for the co-op to take care of its needs.

Senator **Zorinsky**. Then it was not an astronomical sum?

Mr. **Hunter**. No, it was not. Again, since it is discretionary with the Administrator, I will admit we looked at it in a conservative manner, but, at the same time, we tried to be responsive to those situations that indicated need.

Senator **Zorinsky**. In your reply to the chairman's questions about the cost of this program, and I think your reply was, under certain circumstances, $21 billion. Does that make the assumption that you are winding down the program and getting out of the REA?

Mr. **Hunter**. I do not see the relationship, because it does not indicate that.

Senator **Zorinsky**. Well, the cost is not $21 billion to continue a Revolving Fund, is it?

Mr. **Hunter**. It is $21 billion impact upon the Treasury in reduced revenues that can be expected.

Senator **Zorinsky**. These are paper transactions, I am being told by accountants outside of Government, which I think are more objective. I mean, you can use whatever numbers you want and whatever economic philosophy you want, but still I think, when you put out a number of $21 billion, I think the assumption there is to wind it down, and call it in, and do away with any type of Revolving Fund whatsoever.

Mr. NAYLOR. Senator, if we might, we would be pleased to supply for the record the assumptions that were made. We most assuredly did not assume winding down or phasing out the program. It assumed a relatively level of operations. But a large part of that expense reflects commitments for repayment that are already in place and have to be dealt with, and that is the capital fund itself. Unfortunately, coming from the private sector as well as the public, most of those in the private sector have always had a great deal of trouble comprehending the way Government figures funds for budget purposes. Certainly, the offbudget portion of it is more frustrating than most.

I wish it were not the case, but it is.

It is not a paper transfer that we are talking about. It is, in the end, going to be a hard cost. The only variables are the assumptions that are used. We attempted to use reasonable assumptions in making judgments on what the costs might well be.

The CBO and GAO and others that have looked at it have come to very similar conclusions about the prospective costs, and it is substantial.

Senator ZORINSKY. Well, S. 1300 makes the premise that interest rates will be escalated to cover the subsidy cost by the Government in those interest rates, does it not?

Mr. HUNTER. Only to cover the cost of the payment of interest, as contrasted to the revenue from interest payments. So it does not address the indebtedness which REA has the responsibility to meet under the current law.

Senator ZORINSKY. However, if you initiate this type of Revolving Fund, then the commitment made according to S. 1300 would continually be honored, especially if the interest rates were as Senator Andrews pointed out, those that more realistically reflect the original administration's projections.

Mr. HUNTER. I don't agree that the issue is to what degree are we going to reduce user rates.

The issue here is whether user rates are going to be high enough to enable REA, as an agency, to meet its debts that it owes? It owes debts that are represented by CBO's, beneficial ownership. The interest on those is set by an agreement between Treasury and REA. REA owes debts represented by $7.9 billion worth of notes, which are true notes. There are 39 of them. They start out saying, "I promise to pay." They are very clearly a contractual obligation, and the repayment of that is a debt.

If those are going to be abrogated, if those commitments, if those responsibilities are going to be done away with—and they can be done away with, I do not question that a bit, that is the right of Congress and the administration to pass a statute or law which would do that—but, if that is not done, user rates will have to be minimally higher. But it is a very minimal differential.

Senator ZORINSKY. How can they be minimal if the economic shock of an increase of rates in the amounts that you propose has to have a tremendously adverse effect on the rates to the ratemakers?

Mr. **Hunter**. They are minimal. The way you approach that is to figure it out, sit down and use a set of mathematics and make a determination what the factual impact is. So that is why we sat down and did it in a very basic, primitive way, you might say, but at the same time, a factual way. We computed what the impact would be upon the average residential co-op user at the end of the line. And the impact of each percentage point and increase in interest rates will be a half a penny a day. Actually, it does vary from the higher cost to the lesser cost, but you have to accept averages to make analyses.

Senator **Zorinsky**. At the outset of your answer just now, you prefaced it with the words, "All you do is sit down and set up a system of mathematics." My concern is whose mathematics and what they entail.

You know, I have sat at this table and have a hard time finding out what the cost of production of a bushel of wheat is, let alone some of the formulae that are being introduced into this conversation. And that is why I think the bottom line about S. 1300 is what commitment did the administration—what commitment do they intend to make to rural America to continue a viable and sustainable agri-base for this country in addition to offsetting the differential in rural communities in rural America with respect to the absence of density of those people that can pay according to the affordability.

Now, you also said that at this time when we have a deficit in our budget. Your philosophy is very well taken. Does that mean that without a deficit in the budget, that philosophy is not well taken? I can understand that there is a financial crunch to pick up money wherever it can be obtained in the budget. And I think we have torn rural America apart too many times to say that is the place to get it, because the voting strength is not out there in order to fight.

I used to serve on a public power board of directors, the Omaha Public Power District. You know there are advantages in private power that the Government subsidizes indirectly. Tax exempt bonds and many other items that the Government can say, "Well, this is the law." But still it is a subsidy in an indirect way. And I think we should at least make that commitment to rural America. It appears to me that you are at the basis of taking this revolving account and attempting to do with it what a business does, or a bank does with their receivables and assets and outstandings. And you cannot do that in an instance like this because numerically the people that pay the bills are out there and don't justify the action that you are attempting to take.

Mr. **Hunter**. Senator, I do approach things in a real basic way. As I looked at this, I thought in my own mind, I owe some money over at the Waukomis State Bank, in Waukomis, OK, more than I like to owe, in fact. But if I were to go over there and say to my banker, "Some of those notes that I have got over here at your bank, I would like to have you convert that to the capital structure of my farm," I am afraid my banker would not be very receptive to that. And this is precisely, again, in a very primitive way, what I see here, that the U.S. Treasury is the banker for REA. And REA owes the U.S. Treasury, in one case, $7.9 billion. It is not for us to say that REA can assume the U.S. Treasury will look at this as merely a paper transaction, even though there is a relationship in the ownership of REA and the ownership of the U.S. Treasury. Still, there are some differences also, because REA is dedicated to the service of a distinct group of people and citizenry within this Nation. And it is the best citizenry that is in this Nation. I will agree with that because I am part of it. But, on the other side of the coin, it is not the whole Nation.

So the conversion of those notes is more than a paper transaction. It is a transaction that actually transfers a legal responsibility that involves $7.9 billion.

Senator **Zorinsky**. Let me tell you, I would not blame your banker a bit for not loaning you the money under today's circumstances inasmuch as the bankers that I have talked to have lost faith in the Government of this country in its commitment to rural America.

When the banks have that commitment from the Government, they help the farmer to a much greater degree than when you come back to a farm bill and all of a sudden want to freeze target prices. Farmers borrowed and bankers loaned based on what they said the Government was going to commit to in 4 years. Now we are trying to change the rules, as now we are trying to change the rules with rural electric and rural telephones. And that is the basis—you know Wall Street jumps up and down with interest rates based on our whispering anything about reducing the deficit in the Budget Act here, and, likewise, do the banks loan or not loan to farmers of America based on what they perceive to be the commitment of our Government to its farmers. And I think right now it is quite evident that that commitment is not very strong.

Thank you, Madam Chairman.

Senator **Hawkins**. Thank you, Senator.

Mr. Naylor or Mr. Hunter, what is the advantage or disadvantage of dividing the Fund into separate electric and telephone accounts?

Mr. **Hunter**. The advantages that I see are the two programs are relatively separate. Although we as an agency operate both programs we do them, actually, with different personnel. The programs, even a determination of loans are made on different concepts. There is a difference.

Another advantage is that there is a heavy responsibility lying upon the Revolving Fund that relates to our guarantees which mainly are made on the electric side of the program. And heaven forbid it ever happens, but if we have to make good on one of those guarantees, it could have quite a considerable impact upon the Revolving Fund.

And, again, like I say, this threat is more apt to come from the electric side of the program than it is from the telephone side of the program. So I can see reasons why the two programs might be well to be separated. It would merely amount to a little bit more bookkeeping on our part, and we have no problem taking care of that.

Senator **Hawkins**. What are the differences between H.R. 3050, as it finally passed the House, and S. 1300 in the Senate? And why were the changes made?

Mr. **HUNTER**. There were a couple changes made. One of the changes made in the House was to address more specifically the responsibilities of the sufficiency aspects which amended the original version which did not cover the interest being paid, as we interpret the bill, at least, on CBO's. And the later version, the amended version, we think probably reaches to cover the interest rates being paid on CBO's as well as other interest that we pay.

The other change had to do with how mandatory, how restrictive the language is regarding lien accommodations. I am trying to remember some of the language that was used and some of the discussion on the floor of the House, but it finally got down to a term which was interesting, I believe it said "mandatorily discretionary" as to whether or not the Administrator would be directed——

Senator **ZORINSKY**. They mandated that he has to use discretion.

Mr. **HUNTER**. That is right. But, again, it relieved that.

There was also an amendment which touched upon the refinancing of the CBO's and that that had to be agreed upon by the Secretary of the Treasury also.

I think those were the major differences.

Senator **HAWKINS**. Any further questions?

Senator **ZORINSKY**. No further questions. I may have some others in writing, but we have the other witnesses.

Senator **HAWKINS**. That is true. We have two more panels. We thank you gentlemen for coming today and participating in this hearing, and look forward to you participating in future consideration of this issue.

Mr. **NAYLOR**. We appreciate that very much, and we look forward to working closely with the committee. We will provide whatever assistance you may ask with regard to looking at this problem and attempting to deal with it in some fashion.

Senator **HAWKINS**. Thank you.

Mr. **HUNTER**. Let me emphasize we are glad to share with any member of the committee or any Member of Congress or Senate any of the information we have accumulated, which is substantial. We are clearly wanting to get it all out on the table.

Senator **HAWKINS**. Thank you, Mr. Naylor and Mr. Hunter.

The next panel consists of Guy C. Lewis, Jr., Robert D. Partridge, Bob Bergland, David Hamil, and Charles Gill.

If the witnesses will sit in the order they were called, the court reporter would appreciate it.

Guy C. Lewis, Robert Partridge, and Bob Bergland. My good friend, Dave Hamil, how are you? And Charles P. Gill.

Mr. Lewis is president of the National Rural Electric Cooperative Association. Mr. Partridge is executive vice president of the National Rural Electric Cooperative Association. Bob Bergland is executive vice president and general manager-designate, I understand, from the National Rural REA. Mr. Hamil is a member, National Rural Electric Cooperative, and Charles Gill is governor of the National Rural Utilities Cooperative.

We have one more panel after this panel and we have an hour to complete this hearing. So we would ask that you summarize your statements, beginning with Mr. Lewis.

STATEMENT OF GUY C. LEWIS, JR., PRESIDENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. LEWIS. Thank you, Madam Chairman.

I shall be brief. My name is Guy C. Lewis, Jr.[1] I am a resident of Bowling Green, VA, where I manage the Rappahanock Electric Cooperative, a consumer-owned and controlled utility system which provides electric service to about 41,000 members in rural Virginia.

In addition to these duties, it is my honor and privilege to serve as president of the National Rural Electric Cooperative Association, the voluntary service organization of the Nation's some 1,000 rural electric systems, which deliver energy to some 25 million Americans in 46 States.

Madam Chairman, I am most pleased to have the opportunity to present my views on S. 1300, the Rural Electric and Telephone Revolving Fund Self-Sufficiency Act.

Rural electric financing has been of special concern to me personally since the fall of 1981, when my immediate predecessor as NRECA president, Mr. Angus Hastings——

Senator HAWKINS. From Florida.

Mr. LEWIS [continuing]. From Florida, asked me to serve as chairman of a special NRECA Committee on Financing for the Future.

This committee consisted of 17 outstanding leaders, representing every region of the Nation and every segment of the Rural Electric Program. It also benefited greatly from the ex officio participation of three former Administrators of REA, Norman Clapp, David Hamil and Robert Feragen, along with the governor of the CFC, Mr. Gill, who is with us today. We knew even before the committee began its work, however, that the combined effect of extremely high interest rates during the past few years, along with a continuing heavy demand for REA loans, had put strains on the Revolving Fund far greater than had been anticipated at the time of its creation. For this reason, we spent a considerable amount of time working, not only to fully explore and find the problems facing the Revolving Fund, but also in seeking ways by which the Fund could be permanently restored to its financial strength and stability.

From the very outset of this effort, we strongly felt—and still believe—that the REA borrowers themselves, through their national organizations, must take a lead role in creating a workable plan to preserve an adequate and affordable financing program.

This is consistent, I believe, with the reputation that we have worked hard to build as a group ready and willing to assume responsibility for its own destiny—one that comes to Congress not just with problems, but also with fair and reasonable solutions that make good sense for the rural electrics and for the Nation as a whole.

The recommendations of our study committee have been thoroughly evaluated by the full membership of NRECA. The major changes in REA lending policy and practice that would be implemented through the enactment of S. 1300 were discussed at length and unanimously endorsed by the delegates to our 41st annual meeting, in February 1983.

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[1] See p. 168 for the prepared statement of Mr. Lewis.

Our members believe that this is the proper course for us to pursue at this time, and that the long-term future interests of the rural electric systems and their member consumers are best served by accepting an increase in the cost of borrowing today.

We firmly believe that this plan is both reasonable and responsible.

It will establish a self-correcting mechanism for REA interest rates that, if implemented in accord with the spirit and intent behind its creation, will ensure that the Revolving Fund will be able to continue for many years in its vital role as a capital source for rural electrification.

It will provide a means by which rural electric borrowers can, at a controlled and orderly pace, continue to evolve toward greater reliance on private lenders to supplement capital borrowed through REA. It will facilitate this movement to the private market by improving the terms under which REA will share its mortgages with other lenders.

It will maintain the present level of Federal investment in rural electrification by keeping the assets Congress put into the Revolving Fund in 1973 as part of the Fund for as long as they are needed. Under present law, this initial capitalization of the Fund will be gradually siphoned off, beginning in 1993.

Most important, however, is the fact that the proposals contained in S. 1300 will help ensure the continuing fulfillment of a promise made by our Government to the people of rural America nearly 50 years ago: That the comfort, convenience and increased productivity made possible by central station electric service would no longer be reserved only for people in the cities and towns of our country.

America's independent, consumer-owned rural electric systems have done their part to make the dream of universal area coverage electric service a reality. And even though we have come a long way, we still face many of the same challenges that existed in 1935, including low consumer density, difficult terrain, and high cost of power, along with the very high cost of building new facilities today because of inflation.

There is no question that we needed the assistance provided by REA to get the Rural Electrification Program started in the thirties and forties. It is just as clear, I believe, that we will continue to need a strong REA for as long as rural electrics operate largely in areas other utilities could not—or would not—serve.

I truly appreciate this opportunity to be here and speak. I will be glad to answer any questions.

Senator HAWKINS. I think we will have all of the panel members give their statements and then go to questions.

Mr. Partridge.

STATEMENT OF ROBERT D. PARTRIDGE, EXECUTIVE VICE PRESIDENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. PARTRIDGE. Madam Chairman and Senator Huddleston:

If I may, I will ask that my statement be inserted in the record in full,[1] and I will attempt to be very brief in order to leave as much time as possible for questions and for discussion.

Senator HAWKINS. We appreciate that.

Mr. PARTRIDGE. The legislation before this committee is, indeed, a very important piece of legislation to us. It is critically needed, we think, to guarantee the continued stability and the solvency of the Rural Electric and Telephone Revolving Fund.

The keystone of financing for rural electrification has been, and we think will need to continue to be the REA Programs, solidly based, as this bill would make it.

The keystone, of course, of S. 1300 is the provision which gives the REA Administrator new authority, authority that he does not now have, to adjust the interest rate periodically, as may be needed, in order to assure the solvency of that Fund. Additionally, the legislation would capitalize the Revolving Fund, converting over from $7.9 billion of what are, in effect, accounts receivables to capital assets. So the Fund will remain intact beyond 1993. Otherwise, as we well know, the Fund will be drained beginning in 1993 by the payment on the old notes held by Treasury against REA.

There are other features of the legislation that are also quite important to us, including the provisions for accommodation and subordination of liens; features of the bill which provide for refinancing of these certificates of beneficial ownership, when, in fact, there would be an advantage to REA and to its borrowers in such a refinancing. We think that is not an unreasonable proposition because, clearly, the Treasury and the Federal Financing Bank does not lock in for 35 years as the REA borrowers do on the loans at the time they are made. And if, in fact, interest rates fall, as we all hope they will, it seems to us that borrowers and the REA ought to have the benefit of that drop in interest rates. This legislation would make that possible. And we say that it would not cost the Government one bit, because the Government is not locked in for the full term of the loans which have been made.

There are also some other features in the bill that are important and other witnesses, I am sure, will deal with them.

I noted earlier this morning in the hearing considerable attention given to the alleged cost of this legislation. Let me say, categorically, we do not accept the $21 billion cost, which was quoted here this morning. I think it has no basis in fact. And I will be glad to talk about that at length if it is the will of the committee to get into the matter.

Very briefly, the $7.9 billion will remain, and that $7.9 billion is not going to disappear. And the other components of the $21 billion alleged cost really do not have any basis in fact, because the refinancing, which makes up that component, the $8 billion and more than $4 billion of alleged cost. Refinancing checkout done by the administration presupposes that, first of all, the Treasury did lock in at the high rates. They did not, of course. They financed short-term at the lowest rates possible and they will roll that debt over, as they should.

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[1] See p. 171 for the prepared statement of Mr. Partridge.

It is also assumed, in making those calculations, that the interest rate will drop to 6 percent, and that refinancing will occur and the Government will lose the difference. I wish interest rates would drop to 6 percent. I really do not believe it will happen. In any event, if it does, the Government as well as the borrowers and the REA will benefit from the drop. So there is a wash.

I would point out to the committee that the Congressional Budget Office has concluded, along with numbers of others, including NRECA as well, that the net impact of this feature of the bill on the Federal budget will be virtually nil, since requiring REA to make these payments will almost certainly force the Revolving Fund to increase its future borrowings from the Treasury by a corresponding amount.

So we say to you, in all seriousness and all candor that we do not at all accept the $21 billion alleged cost attached to this bill.

Finally, let me point out that we think this measure is worthy of support because it will make the Revolving Fund a kind of perpetual source of financing, self-sustaining source of financing that the Congress had in mind when the Revolving Fund was created in 1973. It will keep the assets of the Fund where they can continue to be used to meet the ongoing needs for financing of rural electrification and rural telephone. It will increase income to the Government-owned Revolving Fund as a result of the increase in interest rates, and that is important. That is really the key to the solvency of the Fund.

It will reduce the need for future Treasury borrowings by expending the internally generated cash flow of the Fund. We think that the measure which has been worked out very carefully over a period of more than 2 years, with the involvement of many, many people, including many congressional leaders on both sides of the aisle, does indeed merit strong support and does need to be enacted into law, and we sincerely hope the committee will find favorably for this bill.

Thank you very much, Madam Chairman.

Senator HAWKINS. Thank you, Mr. Partridge.

Mr. Bergland.

Mr. BERGLAND. Madam Chairman, I have no statement.

Senator HAWKINS. Mr. Hamil.

STATEMENT OF DAVID A. HAMIL, MEMBER, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, COMMITTEE ON FINANCING FOR THE FUTURE

Mr. HAMIL. Madam Chairman, I am going to take the liberty of reading a few brief comments, and then I will be available to you for questions.[1]

First, let me say I am David A. Hamil. I am a resident of Sterling, CO, and have been involved in the Rural Electrification Program for more than 40 years. It has been my privilege to serve as Administrator of the Rural Electrification Administration longer than any other person; that is, from 1956 to 1961 and again from 1969 to 1978.

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[1] See p. 174 for the prepared statement of Mr. Hamil.

It was during my second go-around as Administrator, just about 11 years ago, Madam Chairman, that Congress created the REA insured and guaranteed lending programs that we have today. And I noticed here there has been some comments about moving away from all of Government financing. This is not a new idea with me. I suggested that as far back as 1958. And we have moved considerably.

Let me say that when Public Law 93-32 was put together, I was in on the act, right there. I sat with Members of the House and the Senate, others interested in the program. I was not in on the final rounds that put the bill together. The then general counsel of the Department of Agriculture, Hon. Jack Knebel sat in.

When they completed the bill, they brought it to me and attorney Knebel asked me, "Hamil, can you run REA under these terms?" I took a quick look at the act and determined that it was within reason that we could run it. We did.

A couple of days later, I got a call from the White House. I went over there and visited with three persons from the White House staff. They asked me the same question. The next contact I had with the bill was a call from Secretary Butz to be at the President's office at 4:20, on May 11.

I finally got through the gate and went in, and the President signed the bill, Public Law 93-32, and we were ordered to put it into effect. That was Friday afternoon, and we started in Monday morning. Now, there was not a single soul that had anything to do with Public Law 93-32 that had any idea that we were going to have an oil embargo within 10 months of the date this bill was signed, less than that, in fact. There was not anybody in that room, or no one in the Congress, that I was aware, that had any idea we were going to go into an inflated condition in this economy that would make the changes it did, or that we were going to have interest rates that reached a peak that had never been exceeded in the period of the last 11 years. But all of these things happened. And Public Law 93-32 has taken its place, and there is every evidence now that some changes are necessary.

We could not foresee those things. But here it is today. And I think that S. 1300 is a good start. It may not be a final answer, and there may be something better. If there is, please bring it forward and present it to the Congress of the United States so that they can have the benefit of the experience.

I think that this bill will assist in moving REA from its present certain dependence upon Federal Government, and in time. Rome was not built in a day either, and neither has the Rural Electrification Program. I do not know how much it is going to cost. That does not bother me too much. The reason it does not bother me, I think it is worth every penny that it has cost. It will probably continue to be.

I do not get my information secondhand. I lived in rural Colorado. Do not tell me what it is like. I know. And I recognize that the great production of agriculture in this country, why it is the leading industry that we have. It is more productive per person than any other industry we have. One farmer today feeds 78-plus, and he is getting better. And do not tell me that lights and power have not done it.

Thank you very much.

Senator HAWKINS. Thank you, Mr. Hamil.

[The following letter with attached answers to questions from Senator Hawkins was subsequently received by the subcommittee:]

NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION,
Washington, DC, April 12, 1984.

Hon. PAULA HAWKINS,
Chairman, Subcommittee on Agricultural Credit and Rural Electrification, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, Washington, DC.

DEAR CHAIRMAN HAWKINS: I am pleased to submit the attached answers to the written questions you provided to us following the March 20, 1984 hearing on S. 1300, the Rural Electrification and Telephone Revolving Fund Self Sufficiency Act. We will, of course, be happy to provide any further information that you or your staff may require in conjunction with this matter.

Sincerely,

BOB BERGLAND,
Executive Vice President.

Enclosure.

Question 1. Do you believe that it is fair to continue to treat all cooperatives the same regardless of need? For example, in Florida, my consumers pay far more than most cooperatives pay—shouldn't rates and other factors be considered in determining the level of federal funding?

Answer. There are many diverse operating conditions of each rural electric system which could be taken into account by REA in providing financing. Current REA loan policies do reflect these diverse conditions to some extent. For example, a plant-revenue ratio (PRR) is used by REA to determine each co-op's proportion of non-REA financing. The PRR requires either 10%, 20%, or 30% in higher cost supplemental financing. Also, REA may waive the supplemental loan requirement. REA may also provide financing at a 2% interest rate in extreme operating circumstances, such as very high electric rates or storm damage. Thus, REA loan policies do to some extent differentiate between varying operating conditions of rural electric systems.

S. 1300 provides excellent criteria to guide the Administrator in making insured loans at rates not to exceed one-half of the standard REA interest rates. These include high electric rates, low consumer density, storm damages, low per capita income, and hardship through extenuating circumstances.

Question 2. What are the advantages and disadvantages of dividing the fund into separate electric and telephone accounts? Do both electric and telephone consumers benefit equally?

Answer. Dividing the RE&TRF into separate electric and telephone accounts is a change supported by both electric and telephone associations and the Administration. All assets and liabilities of each program will be placed in the appropriate account. Future loan advances and repayments and expenses of each program will be attributed to the appropriate account. This change is mutually advantageous due to the significant differences between electric and telephone loan purposes, changing program requirements, exposure to economic risks, deregulation, etc. It is believed that both electric and telephone consumers will benefit from this equitable and appropriate change.

Question 3. What are the differences between H.R. 3050 as it passed the House and S. 1300 as offered in the Senate? What were the specific reasons for the changes?

Answer. S. 1300 and H.R. 3050 contained essentially the same provisions when they were introduced. However, the House of Representatives adopted four amendments to H.R. 3050 that are not part of S. 1300. These amendments are as follows:

(1) (Stenholm amendment) The amendment explicitly mandates that the REA revolving fund be administered in such a way as to make certain that interest income equals all interest expense including interest on the indebtedness of the fund incurred before enactment of the bill. This amendment resolves any concern as to whether the bill sets the REA interest rates sufficient to cover all interest expenses.

(2) (Daschle amendment) The amendment requires that loans be made under the special interest rate program; S. 1300 only authorizes the making of such loans. The special interest rate program would provide loans to certain rural utilities at rates of interest below the standard rate charged for loans made through the REA revolving fund. Special rate loans would bear an interest rate of not less than 2 percent

nor more than one-half the standard rate. To qualify, a borrower must meet specified criteria such as, under the amendment, that it has an investment per consumer that is twice the national average. The amendment will also provide funding for the program by setting aside 1 percent of repayments made to the REA revolving fund and require the REA Administrator to review special interest rate loans every five years to determine if the borrower still meets the eligibility criteria. About 60 rural electric systems would be eligible for special interest rate loans.

(3) (Glickman amendment) The amendment specifies that before REA may accommodate or subordinate its liens and mortgages, the Administrator must find that the Government's security would not be jeopardized. S. 1300 only provides that borrowers demonstrate repayment ability since it is difficult to determine what the actual market value of a security such as communications equipment would be if an operation is liquidated.

(4) (Ways and Means Committee amendment) The amendment will require the approval of the Federal Financing Bank before Certificates of Beneficial Ownership issued by the REA revolving fund can be refinanced. S. 1300 allows refinancing at the request of the REA Administrator. This amendment satisfied concerns that the FFB might be required to refinance CBOs.

Question 4. We have heard testimony concerning the benefits to be provided to the rural American farmer under S. 1300 and the need for electricity to handle additional demands for power. Can you tell us what percent of consumers are actually farmers within the cooperatives and how this has increased or decreased during the past ten years (in numbers of consumers and percent of total consumers)? What has been the numbers and percent increase in total consumers during the last ten years?

Answer. According to data reported in the REA Statistical Report of Rural Electric Borrowers, the number of farm and non-farm consumers numberd 8,661,762 in 1982. The number was 5,993,843 in 1972. Thus, the increase was 2,661,919 or annual growth rate of 4.5 percent.

Although REA does not separate its residential consumer class between farm and non-farm, it does list separate data for irrigation agricultural service. The 144,591 irrigation consumers used 4,597,178,000 kwh in 1982. In 1972, 84,599 irrigation consumers used 2,234,562,000 kwh.

Since REA does not distinguish between farm and non-farm use, it is not possible to determine either the percentage of farmers to total consumers or their rate of change over the past ten years.

Senator HAWKINS. Mr. Gill, do you have any comments?

STATEMENT OF CHARLES B. GILL, GOVERNOR, NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

Mr. GILL. Thank you, Madam Chairman, and Senator Huddleston. I, too, as the others, have submitted a statement to the committee and would request that it be filed for the record. With your permission, I will just give a very brief summary of that statement.[1]

Senator HAWKINS. Thank you.

Mr. GILL. My name is Charles B. Gill. I am chief executive officer of the National Rural Utilities Cooperative Finance Corporation, a long title generally known as CFC.

CFC is a cooperative financing organization which presently has 935 members, including 867 rural electric systems. CFC was incorporated in April 1969 to ensure the adequacy of funding to meet the needs not provided by REA.

CFC's financing operations are supported by over 850 million of equity capital invested by its members. Currently, CFC has loans outstanding, loan commitments and guarantees or member debt of almost $8 billion. Of this amount, over $4 billion in loans and guarantees is outstanding to CFC members who are borrowers of REA, and these loans or guarantees are secured with a shared mortgage position with REA.

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[1] See p. 179 for the prepared statement of Mr. Gill.

CFC has a vital interest in section 7 of S. 1300, which would amend section 306 of the Rural Electrification Act. The need for the amendment arises from our experience with REA over the last decade. During this time, CFC has had many delays in processing loans for our members because of what we believe to be restrictive interpretation by REA of the authority of the REA Administrator in granting lien accommodations under the present provisions of the act.

Three considerations appear to determine the Administrator's favorable consideration of a lien accommodation request. These are, first, if there is a compensating benefit to the Government. Second, that there is dollar for dollar physical security in place to match the financing. And, third, that the accommodation be granted only if REA could make a loan for the purpose of the financing.

CFC believes these requirements are overly restrictive in protecting the Government's interests, run contrary to the intent of Congress regarding the infusion of private capital into the program, and are not in the best interest of the rural electric systems or their members.

It is our belief that it would most certainly be in the Government's interest if REA would take a more positive position in granting lien accommodations. We believe that the present policy requiring a finding of adequate physical security to match the amount of outside financing is, and should not be, the controlling consideration in providing capital to our rural electric systems. Rather, revenue produced by that system represents the primary security of the lender. Essentially, this is the same security foundation utilized by all municipal and public power utility financing.

An effect of the present restrictive interpretation is that rural electric systems may not be able to operate as efficiently as they otherwise could in providing electric service to their areas.

The increased efficiency and the infusion of non-Federal capital should be an adequate compensating benefit to the Government. The last consideration that the granting of the lien accommodation by REA is similar to making a loan appears to be a contradiction to the policy stated by the Congress in the 1973 amendments to the Rural Electric Act, that introduction of non-Federal capital into the Rural Electric Program should be encouraged.

S. 1300, if enacted, would enable the REA Administrator to grant a lien accommodation for non-Federal financing upon a finding that such borrowing would not adversely affect the feasibility of operations of the borrower, and that the borrower would have the capability of repaying its existing and proposed indebtedness.

We believe the objectives of the Rural Electric Act, and the interest of the rural consumers, will best be served with the enactment of section 7 of S. 1300.

Thank you, Madam Chairman.

Senator HAWKINS. Thank you, Mr. Gill.

Mr. Lewis, do you think there is any other way to resolve the financial problems of this kind other than S. 1300?

Mr. LEWIS. Madam Chairman, we worked for over a year, 18 of us, looking at every facet, every possibility, alternative, and S. 1300 really is made up of those recommendations. So I would say, no, Ma'am, I do not know of another solution.

Senator **Hawkins**. With the financial difficulty facing the Fund, is it necessary to act right now?

Mr. **Lewis**. I think it is very necessary that we act right now to do something about the revolving fund's inability to maintain a balance. We have got to do something with the interest rates. If we are going to do something with the interest rates, then it is time, in my estimation, to go ahead and do the other things that are involved in the bill.

Senator **Hawkins**. Thank you.

Governor Hamil, I had the great pleasure of serving on the Rural Telephone Bank Board when you were Director.

One of the suggestions that has been around for some time is to bring this activity back on budget. I believe you heard me ask that question previously. From your perspective, being the Director for the longest length of time, what are the advantages and disadvantages of bringing this activity back on budget?

Mr. **Hamil**. Well, I have to make a statement right there that I am always interested in what bookkeepers have to say, but I am not always interested in letting bookkeepers run the business.

I have not seen any real damage, whether it is on the budget or whether it is not on the budget. After all, we have calculators, and we have printed materials. Whether it is on the budget—and Congress maintains the right to determine how much the Administrator can use in each factor, and that is incidental. I might add right there that REA did not run over to the Federal Financing Bank asking them to come and bail us out. They made the statement that they were capable of taking care of our loan guarantee needs.

And, for your information, and I am sure you know this, Madam Chairman, the basic formula for the handling of deals with the Federal Financing Bank was prepared and written right in the Rural Electrification Administration's office without the benefit of any outside talent.

Joe Vellone, sitting over here, can tell you all about it. And it was so pleasing to the Federal Financing Bank that they asked us if they could send their people over and sit down with our folks and prepare a formula, very similar to the one REA had prepared and sent to them, as a basic formula for the use of the Federal Financing Bank's operations.

We had an understanding with them all the time whether or not we should make—or when the loan advances were expected to be made—we had 90-day advances, 60-day advances, and 30-day advances, and I suppose that is being maintained. But I have had little trouble, as long as you are making those loans for a worthwhile purpose. Now, if you are wasting off the resources, throwing it away, you had better have it on budget and you had better know what you are doing for sure.

I have eyewitnessed the REA Program for more than 40 years. I do not see where any loans have been made. Sure, we have a few extra megawatts of capacity in the country right now. Do you know what is worse than having a few extra megawatts capacity? Not having enough.

I just would hate to see the time when we had a real shortage. This country moves on electric power. Sure, we have a few megawatts. Do you know why we have them? Very simple. We had the urge to become energy-independent. We had coal by the millions of tons, by the billions of tons. And REA made loans for coal-burning generating plants to replace gas and imported oil. And at the time we were making these judgments, Madam Chairman, the increase in the use of electricity in the Rural Electric Program was up from 6 to 8 percent annually. If your growth factor is 8 percent, Madam Chairman, that means that you double your capacity in less than 10 years.

Consequently, we were unaware, the best judgment we had within the industry was not that we could forecast that our loads were going to go down—so, consequently, we do have a few extra megawatts of capacity.

I have every reason to believe that with the increased activity that is going on in the business community today, that that will be absorbed very quickly. And, sure we have got some problems with nuclear plants. We put together the Arnold Energy Center in Iowa, from 1969 to the midseventies, when it was dedicated. It has been running like a sewing machine. I cannot understand why they have all of these problems. A lot of it is coming from Government regulations and regulators that probably could not run a popcorn stand. Well, that is the truth. It is.

So, I do not see that this is a major factor, Madam Chairman, whether it is on budget or whether it is not. They know where our money is going. You do not have to have an Arthur Anderson chasing us around to see where our money is going. The Congress knows it, the Federal Financing Bank knows it, the people know it. It is being put to a good purpose. And, while I have got your attention just a minute, I could probably point out, if you would like for me to do the factoring, I can point that by using S. 1300 we could probably create assets of $21 billion. That is rather a job for bookkeepers.

Senator **Hawkins**. A creative bookkeeper.

Mr. **Hamil**. Thank you very much.

Senator **Hawkins**. Off the record.

[Discussion off the record.]

Senator **Hawkins**. The next question will be for Robert Partridge, and I will just ask one or two and I have quite a few that I will submit for the record, in the interest of time, because we would like the other Senators to ask. We are trying to recess by 12:30.

Mr. Partridge, current law treats all borrowers the same by requiring a 70–30 ratio Federal non-Federal funding sources. Are there not certain characteristics among the individual co-ops which are significantly different, such as retail consumer rates, financial strength and the urban or rural nature of the co-op?

Mr. **Partridge**. Madam Chairman, I listened this morning with interest to the discussion on that point. I think the key fact to be remembered though is that all of these rural areas are, indeed, difficult to serve; very high cost in relation to revenue; very low density; very disadvantaged, really. And, even with the advantage of the REA loans, without which it would probably be impossible to serve these areas on any basis, it still is very difficult. As was brought out this morning, our rates, unfortunately, are quite high.

So, to get to the point, and to answer your question, yes, there are differences. I am not sure that those differences argue on the side that there ought to be greater distinction in the kind of assistance made.

I note that no needs test was ever applied in the case of the Federal assistance which was provided to public systems or investor-owned utilities. They all qualify, irrespective for the tax credits, et cetera. They all qualify to issue tax revenue bonds—tax free revenue bonds. In like fashion, the REA borrowers have all been afforded equal treatment, even though there may be some inequalities among them.

Senator HAWKINS. I have several other questions for you, but if you ever run out of anything to do, you would make a great radio announcer. [Laughter.]

Senator HUDDLESTON. I think I will hire him.

Mr. PARTRIDGE. You are very kind. I am available for hire, Senator.

Senator HAWKINS. Senator Huddleston.

Senator HUDDLESTON. I have a number of questions that I want to submit. I have a dean of my college of agriculture waiting for me and I need to leave to meet with him.

However, I have just one basic question: Your members are now borrowing, essentially, at 5 percent from REA. This bill, of course, will make the interest rate variable and higher. Why are you willing to take that step?

Mr. PARTRIDGE. Senator, this is a very good question. I think Chairman Lewis, as chairman of our committee, and his committee members as well, wrestled with the very tough and touchy question of accepting, and volunteering, particularly, to do anything that would further raise the rates that are already too high, and much higher than other adjoining urban type utility systems, but it was the feeling of our committee, a feeling shared, certainly, by all of our members, that it is well worth the price. It is a price that must be borne to assure that we will have a viable financing mechanism; that REA can and will continue to be the cornerstone of the financing for rural electrification, upon which we build all the outside private financing that goes with the REA financing.

So, our members did ask themselves that question, and our committee certainly addressed a lot of time to that. It came down on the side that it must be done if we are going to have a reasonable and viable REA Program, and it must be done now.

Senator HUDDLESTON. Thank you. I will submit the rest of my questions in writing.

Mr. PARTRIDGE. We will be glad to respond, Senator.

[The following questions from Senator Huddleston and the National Rural Electric Cooperative Association's answers thereto follow:]

Question. The financing for the Rural Electric and Telephone programs has evolved over the years from a small direct govennnment loan program to a large sophisticated financing operation that includes insured loans, supplemental loans, and loan guarantees. Would you, for the record, explain the difference in these types of loans and how the interest rates are determined?

Answer. The three types of rural electric financing are as follows:

(1) REA insured loans are made from the Rural Electric and Telephone Revolving Fund, funded from borrowers' loan repayments and supplemented by the sale of Certificates of Beneficial Ownership. These REA insured loans bear a statuatory interest rate of 5 percent, although the REA Administrator may reduce the rate to 2 percent in hardship cases.

(2) When obtaining REA insured loans, rural electric systems are required to obtain a portion of the loan, typically 30 percent, from a non-governmental lender. The National Rural Utilities Cooperative Finance Corporation (CFC) provides most of the supplemental financing.

(3) REA loan guarantees are provided for power supply financing. These are largely funded by the Federal Financing Bank at market rates of interest, plus .0126 percent to cover administrative expenses of the FFB and REA.

Question. Are the insured loans made from the revolving fund the only loans made at a reduced interest rate?

Answer. Yes, all financing to rural electric systems other than REA insured loans are made at market rates of interest.

Question. What is the source of the supplemental loans to the rural electric cooperatives and what interest rate is charged?

Answer. REA requires financing from a non-government source as a condition to receiving an insured loan. The supplemental requirement is typically 30 percent of the loan need. It is provided by the cooperatives own financing institution, the National Rural Utilities Cooperative Finance Corporation, or by a Bank for Cooperatives. The interest rate charged reflects the full private market cost of funds.

Question. What percentage of the total program is the insured reduced rate loans?

Answer. REA insured loans constitute less than one-fifth of total financing requirements.

Question. Have you calculated the blended rate of interest for the total financing program?

Answer. The blended interest rate for REA insured and guaranteed long term financing and supplemental financing is 10.8 percent.

Senator HAWKINS. Senator Zorinsky.

Senator ZORINSKY. Madam Chairman, I would just like to compliment these gentlemen for being foresighted enough to—farsighted enough to anticipate a severe problem looming in the future, and taking it upon themselves, voluntarily, so to speak, to do something about it. Too many times in Government we wait until the crisis is upon us and then we react to that crisis, and then many times too late. I would like to compliment you for the thoughtful premises that you put into S. 1300, and hope that we can, again, Madam Chairman, come to a very expeditious markup and possibly submit some amendments to fine tune this and then get on with the business of returning that credibility again to rural America, that the Government and the United States is behind rural America.

Thank you.

Senator HAWKINS. Thank you, Senator.

We appreciate the panel for participating. Senators can enter their additional questions by writing.

We will now call our last panel, David C. Fullarton and Harold Peterson.

David C. Fullarton is the executive vice president of the National Telephone Cooperative Association; and Harold Peterson is the executive director and counsel for the National REA Telephone Association.

Mr. Fullarton, do you have a statement?

STATEMENT OF DAVID C. FULLARTON, EXECUTIVE VICE PRESIDENT, NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

Mr. FULLARTON. Yes, Madam Chairman. I do have a prepared statement which I would like to have made part of the record.[1] And also, with your permission, a statement of Mr. Joseph Vellone, a member of our staff, which also should be made a part of the record.

Senator HAWKINS. Very well.

Mr. FULLARTON. And also your permission to summarize my statement briefly.

We appreciate being here this morning. And we thank you for scheduling these hearings on what we believe to be very important legislation for, not only the REA Electric Program, but for small rural telephone systems throughout the Nation as well.

As a member of the Rural Telephone Bank Board, where you served capably for a number of years, you are probably more familiar with telephony in rural America, the challenges, problems, and opportunities it faces than most Members of the Congress and we, therefore, appreciate your position on this subcommittee.

The REA Programs have undergone a lot of change over the years. The Rural Telephone Bank, of course, in 1971, with its higher interest rates but also additional capital; the Revolving Fund in 1973—I think the previous witnesses have said enough about that so I do not have to review it.

I would say, however, that we do support the positions and statements of those who appeared just before us from the rural electrics, particularly the statements of Mr. Gill regarding the need for lien accommodations. That is as critical, if not more so, in the telephone program than it is in the electric, primarily because, in addition to the changes we face in the REA Telephone Program, there has been a great deal of change in the telephone industry. When you were Chairman of the Florida Commission, of course, those things were coming down the pike. Not only the technology was changing the nature of the service we offered to rural and small town America, but the competition and deregulation, which has created considerable havoc in the areas that we serve and among our member companies.

Some things have not changed, and that is the low population density where we provide service, and the incident high costs. Also, the continued unavailability of commercial financing, and the continued need for a clear and rational national policy on universal telephone service, for which we are looking very hard in the Congress and before the FCC today.

This legislation, to us, is really looking to the future. You asked Mr. Partridge why or how electric cooperatives could accept the higher interest rates and for what reason. I concur with his answer. The future is before us today in order to assure viable and stable REA financing as the cornerstone of our financial structures. We are also supporting somewhat higher interest rates in return for that stability. But, also in return for those other elements in the bill, which are very, very important to us. The lien accommodation provision, as I mentioned before, is essential. It is essential because in order to survive in a competitive environment, the Nation's rural telephone systems, must diversify; get into types of services other than just plain old telephone service.

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[1] See p. 185 for the prepared statement of Mr. Fullarton.

Those kinds of things are not financed by REA, and we must look to the private money markets to be able to finance those required diversified activities. And, since the lien accommodation that we are talking about is on newly acquired property, not financed by the Government's existing loan, it is essential to have that in order to be able to expand and diversify and keep telecommunications service in rural America at a level that residents there both desire and need.

That is a brief summary of our position.

We do support S. 1300. We also support H.R. 3050 and the amendments that were passed on the floor of the House, if that should be the will of the Senate in reporting out legislation.

We would urge most strongly speedy markup and reporting the bill.

Joe Vellone, if I understand the previous conversation, is a friend of yours. Joe joined our staff in 1982. He serves as staff counsel there and has been the individual most responsible, from our perspective, for the development of provisions of this legislation. Joe has gracefully agreed not to make a verbal statement unless you ask him a question,[1] so you may pass on to Harold for his remarks.

Thank you.

Senator HAWKINS. Thank you.

STATEMENT OF A. HAROLD PETERSON, EXECUTIVE DIRECTOR AND COUNSEL, NATIONAL REA TELEPHONE ASSOCIATION

Mr. PETERSON. Madam Chairman, I want to express the appreciation of our association for the invitation that has been extended to us to appear before this committee to discuss S. 1300.

Accompanying me here today is John F. O'Neal. He is associate counsel for our association. And, expressing the sentiments of Mr. Fullarton concerning Mr. Vellone, I want to tell you that John O'Neal, who is sitting to my left, and Joe Vellone, to my right, are two men who have done substantial and principal work for our respective associations concerning this particular piece of legislation.

I know both Mr. Fullarton and I are grateful for their input and effort. I cannot think of two people in Washington who have a better appreciation of the REA program, both electric and telephone, than these two gentlemen.

I appreciate the constraints of time that we are operating under. I just want to make a couple of brief comments. First of all, I request that my formal statement be included in the record in its entirety, and we would be very happy to answer any questions that the committee might have after my summary presentation is concluded either today or in writing for the record.[2]

I concur with Mr. Fullarton's thoughts that we should try to come to a speedy conclusion in terms of the legislative process so that S. 1300 is not lost as this session of Congress progresses. We hope that in the process it will not be necessary to have another hearing on it. We would be very happy to answer any questions the committee might have and forego any request for any further committee hearing consideration.

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[1] See p. 190 for the prepared statement of Mr. Vellone.

[2] See p. 201 for the prepared statement of Mr. Peterson.

One or two comments I think are in order.

Senator Zorinsky made a comment, and I am glad that he made it instead of myself, because I did not want to be put in the position of being critical of the Congress. I think he certainly———

Senator HAWKINS. Everybody else is. [Laughter.]

Mr. PETERSON. I think he certainly spoke well and with good reason when he said that too often we wait too long to solve some of the problems that face us. As a matter of fact, discussing this very piece of legislation, a Member of Congress recently said, "If we don't have a problem until 1993, why are you addressing it now?"

I think that too often that kind of thinking goes into the judgments that are made. I do not think this is good for our country or ourselves. That is why, as Mr. Guy Lewis has indicated in his comments previously, that NRECA, their organization, had a committee formed over a year ago to really study this and work on it. NTCA'S committee has done the same thing. We have worked very closely with both NRECA and NTCA to try to come up with a solution.

I think that the comment that was made that these REA borrowers, whether they be electric or telephone, today, before 1993, are willing to pay a higher rate of interest for the insured loan is a credit to the responsible feeling that they have toward this program, and the feeling that they have for trying to solve the problem that they know is going to come in the future.

The second point that I want to make is concerning density. As you well know from your previous experience, the REA Program does not enjoy high density in its service areas. On the telephone side, the average density is 5.47 subscribers per route mile of line. The reason I dwell on that a moment is this: In the competitive environment in which the telecommunications industry now finds itself, density means an awful lot. It means an awful lot to those who are really after the competitive dollar, and, believe me, they do not exist in the areas where REA serves. The competitive thrust that is being made in this country today, communicationwise, is between large interexchange carriers who are only interested in about 135 large population centers where there is a high degree of traffic. I can say with justifiable feeling that today the 1,000 some REA telephone borrowers are in a state of semishock wondering what is going to happen to them down the line. The REA Administrator stated earlier, that the number of applications are not coming in now as fast as they did previously. The basic reason for this is very simple to explain.

If you did not know what the future was going to hold 5 years from now, I do not think you would go and put an application in for a loan in REA at this moment. I think we all share their concern that they would want to wait awhile to be sure that they are making a good management decision.

The last comment that I want to make concerns lien accommodations.

Mr. Fullarton touched on that briefly, and I want to reiterate that same concern. Unless we have lien accommodations, which is expressed in this piece of legislation, there is no way that these telephone companies can go out and compete. They have got to get into other kinds of businesses. Any statement that was made previously in this hearing that this bill does not ensure that the security of the U.S. Government will be protected, simply is not true. If a lien accommodation is made under the language of this bill, it is made only after the Administrator ensures himself that the security of the U.S. Government is not going to be impaired.

I want to make that statement very strongly.

I think with that, Madam Chairman, I will close and thank you very much for the opportunity of appearing here before you today.

Senator HAWKINS. Thank you for your participation.

Mr. Fullarton, would you clarify for the committee the problem associated with the section of the bill which deletes the prohibition against making telephone loans in States without a regulatory body unless no duplication of services will result?

Mr. FULLARTON. Would you like to hear from Mr. Vellone at this point?

Senator HAWKINS. Sure.

Mr. FULLARTON. I can do that for you, but he can do it more succinctly.

Mr. VELLONE. This involves the fact that the act contained the provisions on nonduplication way back in 1949, when the telephone program was started. At that time, many people believed that a certificate of convenience and necessity was equivalent to a finding of nonduplication, not recognizing that a State commission, and you were a member of a State commission, has considerable leeway there, and its finding is based on the convenience and necessity for the public, which in today's world would encourage, in many cases, the building of additional facilities.

Now, the problem is the Administrator is required to make a finding of nonduplication only in States where there is no commission with jurisdiction over the borrower. And he does not make that finding in other States. There are 15 States where he has to make the finding. And the way the attorneys like—and I know you have had problems with attorneys in the past——

Senator HAWKINS. Still do.

Mr. VELLONE. And we enjoyed the way you discussed it in meetings of the Telephone Bank Board not too long ago. You realize that a finding of nonduplication, when it is left to Government attorneys, can be very tightly interpreted, so that you would find, in at least 15 States, that it would be quite easy for these attorneys to determine that it would not be within the law to allow our telephone cooperatives to build a connection to another national toll system, because they already had one with the Bell System. You know, in today's world, everybody wants a choice of long distance service. All we are asking is that we give to the REA borrowers in States where the commission does not have any authority over territory the same rights that they have in other States.

There is nothing in here that would cut down the jurisdiction of the State commissions. There is a provision in the law that is not touched which says exactly that, that nothing done under this act will impair the authority of a State commission over an REA telephone borrower.

What we are doing is enabling our small telephone systems to provide service on the same basis as other systems in the States where the commissions have jurisdiction.

Senator HAWKINS. There may be a lot more States. I understand commissioners are quitting like mad since the deregulation of the telephone company. Nobody wants to be responsible for the rates they are going to have to charge.

Mr. Fullarton, or Joe, what is the advantage or disadvantage of dividing the Fund into separate electric and telephone accounts?

Mr. FULLARTON. I think, Madam Chairman, that the Administrator gave a fair assessment of that.

Senator HAWKINS. You agree with him?

Mr. FULLARTON. There is a technological difference. From the point of view of the telephone program, they are a little bit concerned about some of those nuclear loans, although we hope that they all come out all right.

Just a basic technological difference in the provision of electric versus telecommunication services; but we think there is justification in that division. Yes, we do agree.

Senator HAWKINS. What is the cost of eliminating the requirement that all Government capital in the Rural Telephone Bank be furnished by 1991?

Mr. VELLONE. The provision that is added to this bill with regard to class A stock of the Telephone Bank would eliminate that limitation. The reason for putting that provision in the bill is that this administration has made efforts to eliminate the annual appropriation for the purchase of class A stock. And, if the administration succeeds, and it has not so far, in doing such a thing, either reducing the amount of capital or eliminating it entirely in any given year, that would mean that authorization amount would be lost forever and this only encourages the administration to try to circumvent the will of Congress in establishing the present authorization for capitalization of the Telephone Bank.

So this will permit, in case the administration continues its efforts and succeeds, perhaps, in reducing the annual allowance for capital, that authorization would continue until the full amount authorized by Congress has been met.

Senator HAWKINS. Thank you.

Mr. Peterson, in your opinion, what are the reasons for the financial problems facing the Revolving Fund?

Mr. PETERSON. Very simply, Madam Chairman, they fall into two categories. I think former Administrator Hamil spelled it out very succinctly when he said, No. 1, nobody anticipated that interest rates would rise as high as they have, and, No. 2, no one anticipated that the inflationary process that has taken place in this country would be as severe as it has been. It is that plain and simple.

Senator HAWKINS. In your opinion, how much would S. 1300 cost the Treasury?

Mr. **Peterson**. I do not think S. 1300 is going to cost the Treasury more money by its passage than it would cost the Treasury if S. 1300 was not passed.

If nothing is done to solve this problem, the chances are, using the administration's own kind of figures, we would not be ending up with what they claim is going to be $21 billion; we would probably end up with a $31 billion cost to Treasury, if nothing were done. I think this bill is a more responsible way of trying to solve the problem.

Senator **Hawkins**. What do you think of the idea of bringing this activity back on budget?

Mr. **Peterson**. I agree with Dave Hamil, it is six of one and half a dozen of the other. I think that if this country ever decided to go to a capital budget, a lot of problems could be solved. But I do not see any problem here. I think those in the know understand, you know, where the money is going. There is no magic about it, or intrigue or anything like that. Mr. O'Neal here has been involved in this sort of thing for many years when he was counsel for the Agriculture Committee.

John, do you have any comments to make on that?

Mr. **O'Neal**. Well, I think it is important that you not equate being off budget with escaping congressional scrutiny. It is important to note that the 1973 act does require that Congress set the loan levels for each of the programs annually. So many times, in the context of off budget, people think of that as somehow escaping congressional oversight or scrutiny, and that is certainly not the case with the REA Revolving Fund, which is examined annually by the Appropriations Committees of both Houses. The loan levels set for each of the programs is based upon demonstrated need.

Senator **Hawkins**. Thank you.

Mr. Peterson, could you tell me how the Rural Telephone Subscribers Program has proceeded in getting all of the rural telephones to be single-party line, or the equivalent?

Mr. **Peterson**. Bringing one-party service to rural America has attained a most remarkable degree of success. When this program was first started, the guidelines were that there were supposed to be no more than eight parties on a rural line. In those days before REA there, were as high as 25 and 30 parties on a line.

Opponents of the legislation at that time claimed that if you limited it to just eight parties per line, you were goldplating a system and the Government would not get its money back and the program would fail.

In answer directly to your question, Madam Chairman, today approximately 86 percent of our REA telephone subscribers have one-party service.

I think that is a remarkable achievement, and it has been brought about by technology.

Senator **Hawkins**. Thank you.

Senator Zorinsky.

Senator **Zorinsky**. I just have one question I would like to submit in writing, and have Mr. Peterson, if possible, answer for the record again, and I know you touched on it lightly, lien accommodation. I would like to submit this question for the record and, if you can, answer it in a greater depth.

Mr. **Peterson**. I will be very happy to do that, Senator, and we will provide you with the comments we made last August, on that very subject.

Senator **Zorinsky**. Thank you.

National R.E.A. Telephone Association,
Washington, D.C., April 17, 1984.

Hon. Edward Zorinsky,
U.S. Senate, Russell Senate Office Building,
Washington, D.C.

Dear Senator Zorinsky: In accordance with your request at the March 20 hearing on S. 1300 before the Agricultural Credit and Rural Electrification Subcommittee of the Agriculture Committee, I am enclosing my written response for the record to your question concerning the problems associated with REA granting lien accommodations.

I trust that my answer is satisfactory for your purposes. Thank you again for your continued support of S. 1300 and your advocacy of the rural telephone program generally.

With best regards,

A. Harold Peterson.

LIEN ACCOMMODATIONS

Question. I understand that many rural telephone companies with REA loans would like to diversify their operations using financing from commercial lenders. Diversification would seem to enhance the security interest the Government has in such operations. For the record, could you comment on the problems your members have had in getting the REA to accommodate other lenders and what problems this has created for your members?

Answer. Both the National REA Telephone Association (NREATA) and the National Telephone Cooperative Association (NTCA) stressed, in their prepared statements, the need of their member systems for satisfactory lien accommodations and subordinations to enable them to obtain the financing they require which is not available under programs administered by REA.

In my statement, for example, I pointed out that: The changes suggested in S. 1300 will materially improve the ability of borrower to seek non-REA sources of financing. This is particularly important for telephone borrowers who must have the ability to finance for non-Act purposes as they seek to replace their eroding revenue base in the new competitive environment. One of these changes will direct the Administration to accommodate or subordinate liens or mortgages at the request of the borrower for any purpose that would improve the "efficiency, effectiveness or financial stability of the borrower" upon a finding that the borrower has, or will have, the ability to repay its debt.

Mr. Fullarton, in his statement, emphasized that: Since most private lenders require a first mortgage position on new projects or a favorable common mortgage covering existing and new plant, current REA policy makes it difficult—if not impossible—for borrowers to secure financing for worthy projects that could strengthen their overall financial stability and actually enhance the government's loan security.

And Mr. Vellone pointed out in his statement that: REA has adopted questionable policies curtailing the use of REA and Telephone Bank funds for purposes which have traditionally been financed by loans from such sources. Borrowers wishing to borrow funds for these purposes from another lender find that getting REA to share its mortgage lien on satisfactory terms with another lender is a real problem and involves extended delays. REA has an "After acquired clause" in its mortgage which states that REA's lien extends to all of the borrower's property owned or subsequently acquired by the borrower even if the funds for the property were not provided by REA or the Telephone Bank. This clause is being used by REA as leverage to impose conditions on borrowers and lenders which discourage both from entering into such financing arrangements.

If the purpose to be financed by the other lender is a purpose which REA claims it cannot itself finance under the Rural Electrification Act, the problem intensifies. In such cases, REA generally demands a "compensating benefit" for sharing its lien with the other lender. Frequently, this is interpreted as requiring reducing the term of existing REA notes or prepaying one or more notes, conditions which make unattractive activities which would strengthen a borrower's overall financial stability and actually enhance the government's loan security.

In the past, REA has been more liberal than it is today in providing lien accommodations without exacting a "compensating benefit" for purposes which it itself could not finance. Sec. 7(2) of the bill would require lien accommodations "for any purpose that would enhance the financial strength or revenue or improve the efficiency, effectiveness, or financial stability of the borrower, upon a finding that the borrower has, or will have, the ability to repay its existing and proposed indebtedness." Obtaining financing that meets these standards should, in itself, be considered as a satisfactory compensating benefit for REA's action and the determination that the borrower will have the ability to repay all its indebtedness should be considered adequate security protecting the Government's interest. It should be noted that revenue bonds, secured solely by a system's proposed revenues, is the predominant method used for securing loans to many utilities, particularly those owed by Government entities.

Under present policies, negotiations between REA and the borrower over which the borrower's existing notes must be repaid ahead of schedule to satisfy the Administrator's concept of a satisfactory compensating benefit for sharing, on a pro rata basis, the lien on the existing and proposed system with another lender; or for subordinating the lien of the "after acquired" clause to permit the new lender to have a first lien on property financed exclusively by the new lender can extend for as much as a year or more. This frequently causes the borrower to abandon the project as such extended negotiations add materially to the cost of the project by increasing the costs of legal and other professional services even when the prepayments demanded do not deprive the borrower of necessary working capital.

These protracted negotiations also make it difficult to submit timely proposals when adjoining telephone or other telecommunication properties, which could reduce the per subscriber costs of operating a larger contiguous service area, are offered for sale. Likewise, extended negotiations between REA and the other lender over the type and conditions of the lien accommodation REA is willing to make have caused such lenders to withdraw their financing offers.

REA's undue reliance on physical security when there has been no foreclosures on telephone loans since the telephone program was initiated in 1949 is unreasonable. To make certain that this concept does not continue to delay lien accommodations and subordinations needed for financing which will enhance the financial strength or revenue or improve the financial stability of the borrower when it is determined that the borrower has, or will have, the ability to repay its existing and proposed indebtedness, it is recommended that language similar to the following be specifically included in the Report which accompanies S. 1300:

Under Sec. 7 of the bill, obtaining financing from another lender to meet the borrower's credit needs which are not being met by loan programs administered by the Administrator shall be considered as a satisfactory compensating benefit for the Administrator's loan guarantee, lien accommodation, or lien subordination, and the determination that the borrower has or will have the ability to repay its existing and proposed indebtedness shall be considered adequate security for the Government's action.

Senator HAWKINS. Thank you, gentlemen, for helping us out in this hearing today. We will look forward to further hearings on this subject.

The hearing is recessed.

[Whereupon, at 12:35 p.m., the subcommittee recessed, to reconvene at 9:45 a.m., Thursday, April 12, 1984, in room SR-328A, Russell Senate Office Building.]

RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND SELF-SUFFICIENCY ACT OF 1983

THURSDAY, APRIL 12, 1984

U.S. Senate,
Subcommittee on Agricultural Credit
and Rural Electrification,
Committee on Agriculture, Nutrition, and Forestry,
Washington, DC.

The subcommittee met, at 9:44 a.m., in room SR-328A, Russell Senate Office Building, Hon. Paula Hawkins (chairman of the subcommittee) presiding.

Present: Senators Hawkins and Zorinsky.

STATEMENT OF HON. PAULA HAWKINS, A U.S. SENATOR FROM FLORIDA

Senator Hawkins. Good morning.

Today's hearing of the Subcommittee on Agricultural Credit and Rural Electrification is our second hearing on S. 1300. This bill purports to resolve the financial difficulties of the Rural Electric and Telephone Revolving Fund.

During our first hearing on March 20, a wide divergence of views were presented as to the effects of this bill. Diverse cost estimates and a range of effects were predicted if this legislation is enacted. The U.S. Department of Agriculture does not support this legislation. The Rural Electric Cooperative Association, the National Telephone Cooperative Association, and the National REA Telephone Association do support this legislation.

Frankly, differing testimony was not unexpected. I believe each of the witnesses shares the same purpose—to resolve the financial problems of the Fund. Controversy arises, however, over the most equitable and cost-effective approach to solving the Fund's problems.

Today, we will hear testimony on the broader effects of this legislation. Clearly, there are still many questions to be answered. How will S. 1300 affect the rural electric and telephone customers? How will it affect Americans not receiving electric and telephone services provided by rural cooperatives? To what extent should the Federal Government continue to subsidize this industry? What are the characteristics of rural electric cooperatives and how do they differ from one another? The answers to these and other questions should help determine the action of this committee on this important issue.

Interest in the rural electric and telephone programs is growing. I have been approached by a number of Senators and various interest groups who question ways to improve the traditional structure of these programs. Extensive study has been made on this subject. Today, we have but a few of those knowledgeable parties. I look forward to sharing the results and conclusions of these studies with the committee.

It gives me great pleasure to welcome my colleague, the Honorable Max Baucus, U.S. Senator from Montana. We would like to hear from you first.

STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Madam Chairman. I appreciate the efforts that you are undertaking to bring this issue before the Congress. It is a very vital issue and I very much appreciate your initiative.

Madam Chairman, I appreciate the opportunity to share my position with the members of the subcommittee on S. 1300, the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act.

I strongly believe that enactment of S. 1300 is needed to ensure that this country's rural electric and telephone system will be able to continue to provide high quality, affordable electric and telephone service to consumers in rural America.

The importance of Congress taking action cannot be overstated. There are 1,000 rural electric and rural telephone co-ops that serve an estimated 25 million consumers in 46 States.

I urge the committee to consider what we are really talking about when we speak of preserving the solvency of the REA Revolving Fund. Through the Fund, central station electricity now serves 98.7 percent of U.S. farms. Rural telephone service now serves 95 percent of U.S. farms. Without the financing from the Revolving Fund, U.S. agriculture would not have been able to achieve the tremendous growth in productivity that makes U.S. farmers the most efficient in the world.

REA programs contribute significantly to economic development in rural America. Twenty-six percent of the energy needed for irrigation, 15 percent of the energy needed for livestock production, and 100 percent of farm operations, such as milking and egg handling, come from rural electric co-ops.

You cannot speak of rural development without recognizing the role the REA has played. One community development survey indicates that since 1961 REA borrowers have assisted in commercial, industrial, and community projects involving 427,000 jobs, 277,000 additional jobs were created in related industries. In 1979 alone, an estimated 47,000 jobs were created in rural America by REA-financed borrowers.

The record of achievement in rural development is even more impressive when you consider that rural electric and telephone co-ops face larger per capita costs than investor-owned utilities. And they are only able to raise a small percentage of the per capita revenue of investor-owned utilities. Rural co-ops must invest $1,337 per consumer compared with $825 per consumer for investor-owned utilities.

Yet, rural cooperatives receive $3,370 in revenue per mile compared with $42,007 per mile for investor-owned utilities.

Another telling statistic is that rural co-ops build and maintain 50 percent of the electric lines but account for only about 10 percent of the sales.

Madam Chairman, let me briefly return to the need for Congress to enact S. 1300 this year. I would like to share with the committee part of a statement made by Mr. Virgil Fodness of the East River Electric Power Cooperative in South Dakota during an appeal to Secretary Block:

> You and we know that no loan to a rural electric system is to be forgiven, yet that is what the public is being led to believe by USDA statements. Every Cooperative Board represented here is well aware that it will pay its loans as it always has. Furthermore, the legislation we support will raise the interest rates we pay. But we and our representatives studied the problem with the Revolving Fund for a long time because we consider it to be absolutely vital as the basic financing program for rural electric distribution systems. Just because the legislation would make the Revolving Fund permanent does not mean that there is a give-away. The Fund continues to be an asset of the United States Government. We clearly recognize that we are asking Congress to change the Fund's repayments to the Treasury, but we think that is preferable to asking for appropriations for the loan program in order to keep the rural electric systems in operation.

I found Mr. Fodness' statement to be very sincere and very to the point. I hope the administration will tell the committee what their alternative to S. 1300 is and if they continue to oppose the bill.

I would like to know how the administration proposes to lighten the interest cost burden on rural people who are served by rural cooperatives. Consumers, including farmers, served by rural cooperatives in Montana pay the highest costs of any utility users—roughly 24 percent of their bill. Anyone who claims that rural co-ops pay only 5 percent interest does not know that the figure only applies to distribution costs, not the costs of supplying power.

Madam Chairman, let me conclude by saying that S. 1300 is a vital piece of legislation that is aimed at ensuring the long-term viability of the REA financing programs that have meant so much to the development of rural America.

As you know, the House of Representatives has already adopted the companion bill by a wide margin. I urge the Senate Agriculture Committee to send the bill to the floor as soon as possible.

Thank you again, Madam Chairman, for the opportunity to share my views on this important legislation with the committee.

Senator HAWKINS. Thank you, Senator, for contributing to this record.

The first panel will be made up of the Honorable Tom Healey, Assistant Secretary for Domestic Finance, U.S. Department of the Treasury, and the Honorable William A. Niskanen, member of the Council of Economic Advisers, Washington, DC.

If you will sit over there by the microphone, please. We have several inches of paper here, everybody's testimony today. We can all read that for our quiet time. The Senate will be in session at 10:30, and we have a lot of votes that I am interested in. So we would ask that you summarize your statements and answer any questions that we might have.

STATEMENT OF HON. THOMAS J. HEALEY, ASSISTANT SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. **Healey**. It would be my pleasure to do so.[1]

Good morning, Madam Chairman. I welcome an opportunity to present the Treasury's view on the financial provisions of S. 1300 and to outline the concerns that Senator Baucus alluded to.

We have four principal concerns from the Treasury point of view with S. 1300.

The first deals with borrowings from the Treasury. Section 4 of the bill would repeal the requirement for repayment of $7.9 billion of REA borrowings from the Treasury. We are not aware of any justification for the proposed cancellation of this REA debt. Moreover, since this additional $7.9 billion of financing would be provided outside the budget/appropriations process, it would constitute backdoor financing. Accordingly, the Department is opposed to section 4.

The second concern deals with borrowing from the FFB. Section 5 would authorize the Administrator to repurchase without penalty CBO's sold to the FFB whenever the interest rate on an outstanding CBO is at least 100 basis points higher than the current FFB rate. Thus, in a period of declining market interest rates, the Administrator could continuously refund the entire portfolio of some $3.5 billion of CBO's at successively lower interest rates while simply waiting out any periods of rising market rates. This proposal, which is a "heads the REA Fund wins, tails the taxpayer loses" proposition, would provide substantial benefits to the Fund at the expense of the FFB and the Treasury. As stated by the Congressional Budget Office, "This one-way, downward-only, penalty-free refinancing would benefit the Fund at the expense of Treasury, which does not have a similar refinancing option with investors in Treasury debt." There is a mismatch of what the REA Fund can do and what the Treasury can do. Thus, we oppose section 5.

Section 7 would provide a similar roll-over privilege for guaranteed borrowers which directly use the FFB. This proposal suffers from the same criticism as the proposal to refinance CBO's. A correct approach to this roll-over financing does exist. I suggest this in the spirit of looking for solutions. It is incorporated in the November 7, 1983, FFB and REA agreement under which, expressed quickly, the REA-guaranteed borrowers can fund projects with rollovers of short-term 2-year debt during the up to 35-year period when an advance is outstanding. This agreement provides for prepayment of advances by the borrower at any time, but at a market price. The approach is even-handed and recognizes the rights and obligations of all the parties to the guaranteed loan contract.

The third problem we have is with the REA lending rates. The 5-percent and 2-percent minimum rates prescribed in section 6 of S. 1300 would produce a perverse and unintended variation in interest rate subsidies as market rates of interest vary. This results in inequities among borrowers using the program at different times, and also causes extraordinary demands for Federal loans at times of high market interest rates, which are also likely to be the times of greatest inflationary pressures and the greatest need for budgetary restraint.

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[1] See p. 241 for the prepared statement of Mr. Healey.

To give you an example of how this works, at the current cost of long-term Treasury borrowings of about 12½ percent, the cost of making a typical 35-year, $3 million, 5 percent loan, is equivalent to giving an outright grant of $1.6 million and requiring the remaining $1.4 million to be paid with market interest at 12½ percent. In that example, the subsidy is greater than 50 percent of the value of the loan.

The interest rate produced under the formula in section 6 would bear no relation to the Treasury borrowing rate and the Department therefore opposes section 6.

The fourth problem deals with Federal guarantees of tax-exempt securities. Section 7 of the bill would amend existing law to require the Administrator to guarantee loans and to subordinate REA direct loans at the request of the borrower. Such subordination would both increase the Government's risk and, since eligible borrowers would include States and municipalities, the guarantee of these loans would result in Federal guarantees of tax-exempt obligations.

The administration strongly opposes the Federal guarantee of tax-exempt obligations. There are a number of problems with such tax-exempt guarantees. It adds to pressures on the municipal bond market. It crowds out other less creditworthy municipal borrowers, such as municipalities and States who are currently in that market. It increases the borrowing cost of all of those other municipal borrowers and, furthermore, it is an inefficient means of Federal financing because the revenue lost to the Treasury from the tax exemption greatly exceeds the benefits of the subsidy of the tax-exempt rate to the borrower. Accordingly, the Department is opposed to section 7 of the bill.

REA cooperatives have benefited in the past from a wide range of subsidies: subsidized direct loans and guarantees, retention of essentially tax-exempt status while taking advantage of tax incentives, such as safe harbor leasing, tax-exempt municipal bonds for pollution control equipment, and preferential access to low-cost Federal power.

We do not see any justification for large further increases in taxpayer subsidies and, therefore, we strongly urge the committee to reject the legislation as proposed.

As a concluding comment, it is particularly difficult to understand why this kind of legislation—at a time when that buzzer may be for a vote on the commendable efforts of you and your colleagues to reduce the Federal budget deficit—this legislation goes in absolutely the wrong direction.

That concludes my comments, Madam Chairman. I will submit a statement for the record and be happy to respond to any questions.

Senator HAWKINS. Thank you.

You mentioned the deficit which is mentioned about every 20 minutes around here and anything which directly or indirectly contributes to it is under scrutiny.

Can you tell me if S. 1300 has an impact upon the Federal deficit? You stated it did. Do you know how much?

Mr. **Healey**. I cannot give you a direct answer to how much, because how much is in part dependent upon projections of future interest rates. The number of studies that have been done, most by the administration and by the CBO, that have ranged with figures from $15 to $20 billion as potential costs of the proposal. Just to use the easiest example, the forgiveness of the $7.9 billion in loans on an incremental basis means that I in my responsibilities for debt management, because that is one of the jobs that I have——

Senator **Hawkins**. So do I.

Mr. **Healey**. I, over time I am going to have to raise another $7.9 billion of money which I would not have to do if those loans were repaid. So that alone is $7.9 billion.

Senator **Hawkins**. I heard this morning that the IMF, which reschedules debt constantly to foreign countries, has stated that if the United States does not get the deficit down, the rising interest rates will contribute to the ruination of the world. So suddenly it has become very important to the entire world. The $7.9 billion transfer from the Treasury that you mentioned to the Revolving Fund has been called a means of backdoor financing.

Could you explain for the record the concept of backdoor financing?

Mr. **Healey**. The reason it is described as a concept of backdoor financing is because forgiveness of that loan does not have to go through the congressional appropriations process and therefore it is not examined with the scrutiny that is involved in any other kind of programmatic expenditure. That is what is meant by backdoor. It does not go through the normal appropriation process.

Senator **Hawkins**. Are REA loan subsidies currently being absorbed by the Treasury and will this be changed by S. 1300?

Mr. **Healey**. REA loan subsidies currently are being absorbed by the Treasury because the Treasury receives no interest on that $7.9 billion loan.

The amount of subsidy will be increased under this proposal because not only do we not get the interest but we do not get the payment and the corollary of that is the need to borrow additional money and that does provide direct cost to the taxpayer. It just shows up in another part of the ledger.

Senator **Hawkins**. Does S. 1300 affect the Federal budget?

Mr. **Healey**. Under our current method of Federal budget accounting, I do not think that has any impact.

I should have introduced before I started Frank Cavanaugh, the Director of the Office of Government Finance. But I believe all of these transactions are currently off the budget and would not have a direct budget impact. That is, frankly, one of the concerns and one of the items in the Agriculture Department proposal of alternate legislation for this, which would put the REA loan activities on the budget so it would be subject to that scrutiny.

Senator **Hawkins**. When the original notes were signed between the REA and the Treasury, which comprise $7.9 billion that you discussed, I assume those notes were legal and binding upon the REA to be repaid under the agreed to terms; is that true?

Mr. **Healey**. To the best of my knowledge, that is correct.

Senator **Hawkins**. What is the amount of notes from other agencies, like the REA Revolving Fund due to the Treasury in future years?

Mr. **Healey**. The total amount of borrowing through the Federal Financing Bank is on the order of $135 billion at the moment.

That is broken into a myriad of different programs.

Senator **Hawkins**. Is there any concern that others will propose the same type of arrangement for their notes as is proposed in S. 1300?

Mr. **Healey**. I think there clearly is and that is why we, as the Treasury, come with a very narrow constituency; it is all the taxpayers and we try to be even-handed in the way we approach that.

Clearly, if any one group or interest is allowed forgiveness of their debt, then all of the others—I am just looking at some of the various programs. They range from the Commodity Credit Corporation, the Small Business Administration, the Tennessee Valley Authority, the Export-Import Bank, the Postal Service, the Railway Association, I could go on. Why do not I submit for the record a list of some of the principal agencies and the amounts?

Senator **Hawkins**. Please do.

[The following information was received by the committee:]

TABLE IV.—SCHEDULE C (MEMORANDUM)—AGENCY BORROWING FINANCED THROUGH ISSUE OF PUBLIC DEBT SECURITIES

[In millions of dollars]

Classification	Transactions			Account balances current fiscal year		
	This month	Fiscal year to date		Beginning of—		Close of this month
		This year	Comparable prior year	This year	This month	
Borrowing from the Treasury:						
Commodity Credit Corporation	681	−4,336	3,643	21,407	16,390	17,071
Commerce, Fishing Vessels NOAA		9	3	9	18	18
Export-Import Bank of United States	31	118	29		87	118
Federal Emergency Management Agency:						
National Insurance Development Fund			10	50	50	50
National flood insurance fund		63		50	113	113
Federal Financing Bank	1,848	1,636	3,360	136,082	135,870	137,718
Federal Housing Administration:						
General insurance				2,010	2,010	2,010
Special risk insurance				2,024	2,024	2,024
General Services Administration:						
Pennsylvania Avenue Development Corporation		5	−1	56	61	61
Government National Mortgage Association:						
Emergency home purchase assistance fund	−33	104	−90	2,265	2,403	2,369
Special assistance functions	−101	450	601	8,816	9,367	9,266
Rural Communication Development Fund		3	4	14	17	17
Rural Electrification Administration	−60			7,865	7,924	7,865
Rural Telephone Bank		30	31	721	751	751
Secretary of Agriculture, Farmers Home Administration:						
Rural housing insurance fund		340	75	2,621	2,961	2,961
Agricultural credit insurance fund			75	2,925	2,925	2,925
Rural development insurance fund			55	1,275	1,275	1,275

TABLE IV.—SCHEDULE C (MEMORANDUM)—AGENCY BORROWING FINANCED THROUGH ISSUE OF PUBLIC DEBT SECURITIES—Continued

[In millions of dollars]

Classification	Transactions			Account balances current fiscal year		
	This month	Fiscal year to date		Beginning of—		Close of this month
		This year	Comparable prior year	This year	This month	
Secretary of Education:						
College housing loans				2,687	2,687	2,687
Secretary of Energy:						
Bonneville Power Administration	−20	30	70	1,165	1,215	1,195
Secretary of Housing and Urban Development:						
Housing for the Elderly and Handicapped		300	431	3,711	4,011	4,011
Low-Rent Public Housing	−30	35			65	35
New communities guaranty:						
Title IV		−8		8		
Title VII		−376	17	376		
Urban renewal fund			−50			
Secretary of the Interior:						
Bureau of Mines, helium fund				252	252	252
Railroad Retirement Account	150	1,442			1,291	1,442
Secretary of Transportation:						
Aircraft Purchase Loan Guarantee Program		12		79	91	91
Rail Passenger Service Act		1,120			1,120	1,120
Railroad Revitalization and Improvement			−4	1	1	1
Rail Service Assistance		−1	−1	6	5	5
Regional Rail Reorganization		22	79	263	285	285
Small Business Administration, Disaster Loan Fund			−250			
Smithsonian Institution:						
John F. Kennedy Center parking facilities				20	20	20
Tennessee Valley Authority				150	150	150
United States Information Agency						
Veterans Administration:						
Veterans direct loan program				1,730	1,730	1,730
Total agency borrowing from the Treasury financed through issues of Public Debt Securities	2,466	998	8,087	198,638	197,169	199,,636
Borrowing from the Federal Financing Bank:						
Export-Import Bank of the United States	508	622	278	14,676	14,789	15,296
National Credit Union Administration	4	−6	−36	44	33	37
Postal Service				1,154	1,154	1,154
Tennessee Valley Authority	−70	−35	390	13,115	13,150	13,080
U.S. Railway Association		−14	−69	125	111	111
Total borrowing from the Federal Financing Bank	442	567	563	29,114	29,237	29,678

Note: Includes only amounts loaned to Federal agencies in lieu of agency debt issuance and excludes Federal Financing Bank purchase of loans made or guaranteed by Federal agencies. The Federal Financing Bank borrows from Treasury and issues its own securities and in turn may loan these funds to agencies in lieu of agencies borrowing directly through Treasury or issuing their own securities.

Source: Monthly Treasury Statement of Receipts and Outlays of the U.S. Government, Mar. 31, 1984.

Mr. HEALEY. I would say that they do affect almost everyone and I would expect that if this goes through everyone of these other borrowers will, with some justice, come and complain to our office or to the Secretary that it is their turn to have theirs forgiven.

Senator HAWKINS. How many programs besides REA are financed by the Federal Financing Bank selling CBO's?

Mr. HEALEY. The Farmers Home Administration is the only other one that directly uses the CBO mechanism. There are four others that involve sales of agency assets to the Federal Financing Bank: the health maintenance organization program of DHHS, the medical facilities program, OPIC, and the Small Business Administration.

Senator **Hawkins**. How would the downward only financing provisions of S. 1300 affect the Treasury?

Mr. **Healey**. The FFB finances through the Treasury in the open market at fixed rates and with a variety of maturities all the way from very short 3-month borrowings to long 30-year borrowings. With the exception of the long borrowings, which have a prepayment provision after 25 years, essentially none of that borrowing can be prepaid. In a time of declining rates, the prepayment provided in S. 1300 would allow the REA to prepay borrowings that were borrowed at high interest rates and then refund them at lower interest rates. Let us say that they borrowed today at 12½ percent and that interest rates went down 2 years from now to 10 percent, they would prepay the amount of borrowing at 12½ percent and take out a new loan at 10 percent.

The problem with that is that the Treasury does not have a corresponding ability to take an equal amount of that debt and prepay it to the people we need to borrow from and therefore we are stuck with borrowings at old, high rates, whereas the REA under this proposal would be able to prepay and reborrow at low rates. That rate differential between the lower rates of future time and the higher rates that we have to borrow at today would be absorbed by the FFB and therefore by the taxpayer.

Senator **Hawkins**. Would the Treasury be opposed to setting REA interest rates at some predetermined rate with respect to the cost of money to the Revolving Fund, maybe some percentage below the cost of money to the funds?

Mr. **Healey**. There are two parts to that question. We already have a program we put in place last year with the REA with 2-year revolving notes where the borrowing is at the market for a 2-year period. At the end of 2 years they come back and they could be refinanced at whatever the market rate is. That perfectly matches the REA payments to the Treasury payments at a market-to-market correspondence. We are happy with that and we really are happy to work out with the REA any other kind of proposal that is even-handed and that does not put additional risk on the Treasury. That is one part of your question.

In terms of working out a workable financing technique, I think we have one and one that REA is happy with, but we could explore others.

The other question of whether there should be a subsidy involved in that borrowing is really a program question and one that, from the point of view of the Treasury, I do not think I am able to give a direct answer to. Clearly, there are situations where it might be appropriate to have a subsidy from agriculture that would be appropriate.

Senator **Hawkins**. Senator Zorinsky has joined us.

Do you have a statement, Senator?

Senator **Zorinsky**. I will submit my statement for the record.[1]

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[1] See p. 233 for the prepared statement of Senator Zorinsky.

Senator HAWKINS. This is our first witness, Tom Healey, Assistant Secretary for Domestic Finance, from the Treasury. We have not heard the statement yet from the witness from the Council of Economic Advisers. But if you would like to question Mr. Healey at this time.

Senator ZORINSKY. I would like to ask, since the administration has indicated that it opposes S. 1300, which I assume is a true statement. The administration has also recently requested rescission of funds that were appropriated to the REA Revolving Fund. Since it appears that REA will have to stop making loans after 1990, unless appropriations are made, or in the event S. 1300 is enacted, what does the administration propose as a solution to the problem?

Mr. HEALEY. Let us see if I can understand your question and encourage Bill Niskanen if he would like to get involved.

I am not aware of any proposed rescission of funds. I do not think anybody in the Treasury is. Maybe you could explain a little bit better what you mean by that.

Senator ZORINSKY. I am informed that the Appropriations Committee had just appropriated $196 million to that Fund and the—it is the first time appropriations have been made to that Fund and the administration very recently asked for rescission of that Fund.

Mr. HEALEY. I am honestly not aware of that, Senator. I am not sure how—from the Treasury——

Senator ZORINSKY. But without it, obviously the hypothesis I set before you will take place in 1990 whether you are aware of it or whether I am alive or dead or whether you are still in the Treasury Department it is going to happen if there is no funding.

Mr. HEALEY. Your question—let me see if I can understand the second half of your question then. The second half of your question is that if there is no rescission, then——

Senator ZORINSKY. Well, there definitely has been a request for rescission even though you are not aware of it.

After 1990, unless the appropriations are allowed or unless S. 1300 is enacted, one of the two, the program will come to an end. The administration is opposed to S. 1300 and they have asked for rescission of the Fund, what is the administration's alternative or what do they propose as a solution to the problem?

Mr. HEALEY. I guess the short answer, Senator, is that as we talked about a little bit in the beginning, the Fund has legally binding obligations to repay the Treasury and should do so, just as all other borrowers who borrow from the Treasury.

Senator ZORINSKY. Has Argentina repaid you yet?

Mr. HEALEY. I do not know that there are any loans from the Treasury to Argentina. Well, I am not aware of it.

Senator ZORINSKY. Where does the Treasury get its money?

Mr. HEALEY. The Treasury gets its money from a combination of taxes paid by everyone and borrowings from the public market.

Senator ZORINSKY. Well, would you say directly or indirectly that Argentina and Mexico through the International Monetary Fund or World Bank, they may have some of our tax money?

Mr. HEALEY. They certainly may. I cannot, as a matter of direct knowledge say that I know that. But it seems likely.

Senator ZORINSKY. If they do not, they have got some pretty huge printing presses someplace in the world.

Anyhow, getting back to my original question, you say you would like to have them repay it. But if they kept up with the interest on the principal in a revolving fund and did not pay it, and still the Government was indemnified and the Treasury Department was indemnified, the Treasury Department and the taxpayers of this country would not be penalized in the area of interest, inasmuch as the floating rate would always keep up with the Revolving Fund. Therefore, do not you feel that our No. 1 industry in this country is worth saving on that account. Let me remind you that yesterday our Foreign Relations Committee appropriated $11 billion to foreign aid that you will never see again.

Mr. HEALEY. Let me see if I can answer the question as you have stated it.

You say the taxpayer is not penalized if the interest is paid. It is my belief that indeed the interest on this $7.9 billion has already been forgiven and is not paid to the Treasury. So the taxpayer is already penalized from that point of view in not receiving interest on the $7.9 billion.

Senator ZORINSKY. But you come here as a representative of the administration, you know, you are not unique, regardless of what administration, you are representing that entity of the Government according to our Constitution. However, you are in the Treasury Department and you are involved in distributing money through the channels to food stamps and unemployment compensation. Have you asked for any of that money back?

Mr. HEALEY. For better or worse, I am employed and so I do not get unemployment compensation.

Senator ZORINSKY. And part of the deal is you will never get it back.

Senator HAWKINS. Thought you would like to know that one of his responsibilities at Treasury is the credit manager.

Senator ZORINSKY. You are credit manager?

Mr. HEALEY. Well, one of my responsibilities is the management of the debt. But the answer to that question, I think in part, is that if the $7.9 billion is not repaid, then the taxpayer is hurt because over time that is $7.9 billion more that the Treasury does not have and therefore has to borrow. And there are interest payments on those future $7.9 billion of borrowing and there are capital market impacts of that $7.9 billion of borrowing. When that occurs, that hurts every taxpayer.

Senator ZORINSKY. What percent of our GNP is that?

Mr. HEALEY. I would have to calculate it.

Senator ZORINSKY. It would be very infinitesimal, I would assume.

Mr. HEALEY. Well, I would only respond by saying that everybody in the administration and in the Senate and in the House are spending literally night and day trying to make cuts in the Federal budget deficit and as you know more painfully than I, every dollar comes with agony and I submit that unfortunately this proposal is going in the wrong direction. I know you were here last night worrying about it.

Senator ZORINSKY. I think it is going to do nothing but make money for the Nation. And I will tell you when you do not have a viable electric system in rural America, one that is affordable to farmers, their costs will have to be passed on to the consumer. When the consumer can no longer afford to buy the farmers' produce, everybody is the loser.

Rural America to a great degree was built by the REA's, as I am sure you are well aware.

Mr. HEALEY. I think the program has been an outstanding success.

Senator ZORINSKY. Now, as farmers go out of business, as people lose their jobs, as people lose their livelihood, as REA's lay off employees, that means those people get to go to a different set of circumstances in our system. That means they are eligible for food stamps, they are eligible for unemployment compensation, they are eligible for all of those things that you will not ever come in here and ask us to pay back.

Now, I would rather have money that generates an economy to this country, especially when it is being used to offset deficits of budgets throughout--deficits of trade throughout the world. Certainly agriculture is one of those areas that is helping it not be worse than it is. That is why I cannot understand why this administration or any other administration would object to keeping REA alive, because what you are doing is condemning it to dismantlement by opposing this bill and by coming here to speak against it.

Mr. HEALEY. From the point of the Treasury, Senator, I do not in the main disagree with any of the comments you are making about the contribution of the REA. But if there is to be a subsidy for that particular section of the economy, then that subsidy should come from the normal budget appropriation process so it is visible, debated, understood, and approved by you and your 99 colleagues and not in what I refer to in my testimony as a backdoor fashion. The amount and nature of future subsidy to the REA Program is frankly beyond my competence as a witness from the Treasury to answer.

Senator ZORINSKY. Well, you talk about costing $7.9 billion. At most, it would require $500 million a year over a 40-year period in new borrowings, if it had to be borrowed. $7.9 billion would be repaid from 1993 to 2070.

So why do you use that figure, as you know, being thrown out the window?

Mr. HEALEY. Because that is the amount of money that the Treasury is owed under the notes that are signed by the REA Administrator.

Senator ZORINSKY. But this is like all the banks coming in calling all their notes in on one day and saying they are all due today.

Mr. HEALEY. I do not think anyone is suggesting, that I know of, no one is suggesting that the REA prepay that $7.9 billion. I think you are the first one I heard that suggested that.

Senator ZORINSKY. Well, that is because the inference is made that this is going to immediately cost the taxpayers this amount of money and it is erroneous.

Mr. HEALEY. I did not mean to make that inference. I do not think I said that in my statement.

Senator **Zorinsky**. You keep using the words "$7.9 million" (sic) as a cost.

Mr. **Healey**. Unfortunately it is "billion," not "million." I wish it were a million.

Senator **Hawkins**. In Washington it is a billion.

Senator **Zorinsky**. Well, thank you.

Senator **Hawkins**. Thank you, Senator.

Thank you, Mr. Healey.

We will now hear from the Honorable William Niskanen, member of the Council of Economic Advisers. If you could summarize your statement for us, we would appreciate it.

STATEMENT OF HON. WILLIAM A. NISKANEN, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. **Niskanen**. Thank you, Senator Hawkins.[1]

My remarks today briefly address the general economic issues bearing on the question of whether to increase interest subsidies to the REA.

First, I will try to establish that the original objectives and rationale for the REA established back in the 1930's are no longer relevant today.

Second, that the interest subsidies are an inefficient way of helping rural households; third, that they discriminate rather severely against people in different income and regional groups; and, fourth, that the subsidies to the REA and telephone co-ops are much larger than any investment incentives available to the investor-owned utilities.

The REA has largely served its original purpose. Ninety-nine percent of farmers are now served by central station electricity, 95 percent of farmers by telephone.

Most of the new consumers of the REA are not the farms but are rural and suburban households. The number of consumers served by the electric co-ops increased 50 percent since 1970. The percentage of U.S. farms that were served by REA increased by less than 1 percent.

The REA has changed from spending most of its money on retail distribution to spending most of its money on generation and wholesale distribution.

The proportion of new commitments in generation and wholesale distribution increased from 22 to 83 percent since 1970.

In addition, when the original legislation was passed it was widely believed that rural areas were insulated from urban financial markets. That is no longer the case. Rural and urban financial markets are extremely well integrated today; branch banking and correspondent banking offer substantial access to major financial centers as do electronic funds transfers.

Another justification for REA and other programs during the 1930's is that the farm family incomes were much lower than that of nonfarm incomes. This is no longer the case. In 1982, the average pretax income for farm families was $25,600 compared to an average of $27,400 for all families. And this overstates the after-tax difference because of the preferential tax treatment of farm income.

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[1] See p. 247 for the prepared statement of Mr. Niskanen.

The REA has contributed to substantial improvements in the well-being in rural areas. Maybe now is the time to declare victory and to question whether increased subsidies would serve any important purpose.

Second, the subsidies are wasteful in the sense that they are inefficient ways to help the presumed beneficiaries. They distort the choice of production processes in favor of more capital-intensive processes and they distort the choice by consumers of different means to heat and cook and otherwise provide power in their home. There is evidence that the availability of these subsidies has contributed to a change in which power generation by the REA borrowers has increased from about 28 percent to 42 percent of the electricity used by the consumers of these co-ops just since the REA amendments of 1973.

A study by the National Economic Research Associates suggests that the underpricing of electricity by the co-ops as a consequence of the subsidies leads to over-use of electricity by the beneficiaries by about 4 percent. In short, the interest subsidy makes electricity production too capital intensive and it induces consumers to waste electricity—both wasteful production and wasteful consumption.

Third, I think there is increasing reason to question whether the REA subsidies are equitable. They are not effectively targeted either by region or by income group any more. Most of the new consumers are not farmers, many of them are in suburban areas, many of them are consumers with incomes substantially above median income in the country.

In general, these subsidies force taxpayers to subsidize the electricity consumption of a part of the population, even while the same taxpayers must pay the higher prices for their own electricity.

Finally, there has been an unfortunate and misleading controversy about the magnitude of subsidies to the co-ops relative to investment incentives provided in the tax code to investor-owned utilities. I think the comparison is misleading. But in any case, two recent studies, one by the National Economic Research Associates and one by the Congressional Research Service, have concluded that the subsidies to the co-ops are much larger than the investment incentives to investor-owned utilities.

But in fact, you do not really need the evidence on this. Co-ops do not pay Federal income tax on income derived from electric power sales, while investor-owned utilities do pay such taxes. Because these investment incentives—the investment tax credit and accelerated depreciation—do not reduce the utilities tax liability below zero, the best an investor-owned utility can do is pay no taxes and only in that rare case would they be on a par taxwise with the co-op.

At the same time, of course, the investor-owned utilities must pay market interest rates for capital while the co-op pays much lower rates.

If it were true that investor-owned utilities were advantaged relative to co-ops, then probably we should expect co-ops to drop the tax-exempt status and federally subsidized loans to become taxable entities. That has not been the pattern.

In conclusion, interest subsidies to REA co-ops are an inefficient means to assist rural households. These subsidies bias the choice of technologies for producing power and the choice of means to provide heat, cooking and so forth to homes. The subsidies are not well targeted to rural residents or to low-income houses. This misallocates capital between the co-ops and investor-owned utilities.

The conditions that originally invited these subsidies are substantially changed today, in part as a consequence of prior REA Programs.

But increasing the subsidies, as called for under S. 1300 is not sound economics. A better alternative to this bill is to make adjustments to the program, to put the fund on a sound basis by increasing interest rates and by encouraging borrowers to increase their reliance on the private sector credit markets.

Thank you.

Senator HAWKINS. Thank you.

We have all heard lots of arguments about whether these and other programs should be off budget. In a case like this, does the program, despite being off budget have any effect on credit markets?

Mr. NISKANEN. The fact that it is off budget does not change its consequence on a credit market. I think the primary effect is to reduce the attention of Congress and the executive to that program.

I and my predecessors in the Council have long supported putting such activities on the budget, with the expectation that both the administration and the Congress would give it more regular and more intensive scrutiny.

But our governmental accounting mechanisms as to how we treat that do not affect the ultimate economic consequence.

Senator HAWKINS. CBO has estimated the cost of this bill to be $10.4 billion.

Does this bill have any kind of a multiplier effect on the credit market beyond the reported cost?

Mr. NISKANEN. I think that the best estimate—the $10.4 billion or some other number, whatever is the appropriate number in terms of the present value of these subsidies, should be judged on its own merit. I do not think that it is terribly important to take into account marginal effects of this particular borrowing on, say, interest rates to all borrowers. Presumably every amount of Government borrowing contributes something to the interest payments and interest rates of all other borrowers but that effect is so small as to be, I think, not terribly important.

Senator HAWKINS. How do you respond to the argument that S. 1300 would cost the Government nothing, because it simply transfers money from one Government entity to another?

Mr. NISKANEN. If this $7.9 billion is not repaid as scheduled over a period of time beginning in 1993, the Treasury will either have to borrow that much more or tax that much more relative to a condition in which it would be paid.

Senator HAWKINS. Do you feel it would establish a precedent for other Federal borrowers to attempt to avoid repayment of their debt?

Mr. NISKANEN. Senator Hawkins, you are probably a better judge of that than I am. We are concerned that it might establish a precedent because there are many tens of billions of dollars of such commitments outstanding and that a forgiveness of the debt load by a particular group is much more likely to increase the demands for similar action by other groups.

Senator HAWKINS. The movement away from rural areas reversed between 1970 and 1980, according to the 1980 census the rural population increased by 10.4 percent, which was almost as high as 11.9 percent increase in the urban population.

How do you respond to the argument that we need REA subsidies more than ever to meet the demands of these new rural households?

Mr. NISKANEN. I do not understand how an argument is used in both directions to justify REA subsidies. A large part of the earlier justification for such subsidies was low density, or in many cases declining population, and now we find in a decade with substantial increase in rural population the opposite argument is also used. Increasing population in the rural areas should lead to economies in the provision of electric power in these areas and do not provide a basis for increased subsidies.

I think there should be no presumption that the increase in the number of households in rural areas must and need be served by the REA co-ops. That will be a function of public policy itself in terms of the extent and level of continued interest subsidies.

Senator HAWKINS. Is it your personal feeling that the REA's heavy investment in nuclear energy, reported in The Wall Street Journal on February 9 is the result of an incentive to invest in overly capital-intensive power production?

Mr. NISKANEN. Any subsidy of interest rates is likely to lead to the use of a more capital-intensive production process or distribution process than would otherwise be the case.

Nuclear energy and hydropower are the most capital intensive of the means to produce electric power. And although we have not demonstrated a cause and effect relationship there, I think there is an intelligent presumption that interest subsidies have induced the REA's to rely in recent years especially on nuclear power.

Senator HAWKINS. Do you feel that a better targeting mechanism would enhance equity under the program? I understand that millions of Americans who get less-expensive hydroelectric power also get the REA subsidy. This is true, despite the fact that their cost of electricity is only 70 percent of the national average.

In your opinion, is this a wise use of our resources to treat all cooperatives exactly the same regardless of the circumstances or do you feel that we might consider various circumstances of individual co-ops and their consumers in determining how extensive our Federal involvement would be?

Mr. NISKANEN. Senator, that is ultimately a political judgment in terms of which groups Congress intends to help.

As I remarked, the REA subsidies are not especially well targeted to low-income people, they are no longer basically targeted to farmers, they are not particularly targeted to people who would otherwise pay unusually high electricity rates. If the objective of Congress, which may be understandable, would be to help those with say especially low incomes or those with what would otherwise be especially high electricity or telephone charges, then a much more effective mechanism than REA subsidies could be designed. Something in the nature of a power voucher or a telephone voucher, something of that nature directed specifically to the consumer that Congress chooses to help, would be far more efficient than general interest subsidies to REA co-ops of all kinds.

Senator **Hawkins**. Senator Zorinsky.

Senator **Zorinsky**. Thank you, Madam Chairman.

Since you do not accept appropriations process, and since you do not like S. 1300, I assume I could put you down for leaning against S. 1300. You propose to shut down the REA program in 1990?

Mr. **Niskanen**. Sir, that is not my judgment to make. I think that——

Senator **Zorinsky**. Do you think it should be?

Mr. **Niskanen**. Let me respond in two ways. I think that if Congress wishes to subsidize the REA, it should do it on budget through the appropriations process.

Now, the administration may choose to support or oppose that, but our clear position is that those subsidies should be above board, should be on the budget, and operated through the budget process.

Senator **Zorinsky**. You talk about above board, and you use the word backdoor financing. That indicates that Congress does not scrutinize, obviously, you know, it has got to come in the backdoor instead of the frontdoor, on budget instead of off budget, that implies to the people of this country that it is happening without anyone's knowledge.

I would like to point out that REA loan levels are authorized by both the House of Representatives and by the U.S. Senate, on an annual, basis. So all these cute words to mislead the people of this country that something is happening to their money, that is not creating an accountable situation, shows a very big lack of understanding of how these moneys are acquired back here.

I do not think it is in the best interest of anyone being served to use these types of adjectives to describe something when the scrutiny is there, and the authorization is there, especially in both Houses of Congress.

I would like to ask a question, because you made a comment about the difference between private electric entities and REA. The question I have is, if investment tax credits and accelerated depreciation that is available to investor-owned utilities is targeted only to the investor-owned systems, because obviously that is a cost to the Treasury also? It is something that the private investor-owned utilities would fight tooth and nail to retain, because obviously it has a reflection on their capability of setting lower electric rates, and you make a big thing out of what REA is doing for targeting, but my question is, do private investor-owned utilities target their depreciation schedule and their accelerated depreciation that is available to them and the investment tax credits that they receive?

Mr. **Niskanen**. Senator, I do not consider a circumstance in which people are taxed less than 100 percent of their income as a subsidy. That is the only basis for contending somehow that the Treasury is giving money to investor-owned utilities, when it fails to tax all their income.

I would object to that similar concept as applied to individuals, and I see no reason to use that comparison for investor-owned utilities, or any other form of investment.

The combination of the investment tax credit and the accelerated depreciation allowances in the 1981 tax legislation was designed to reduce the bias of the tax system against private investment in the United States. They do not eliminate it. There is still an existing tax bias against private investment, and the combination of these actions has not, for most classes of investment, reduced the effective tax rate to zero.

So the fact that the tax rate on the income from business investment was reduced in the 1981 bill, does not mean that that is a grant of resources from the rest of the American community to these people. It is just reducing the bias against private investment that was previously the case. A bias, however, that still exists in some magnitude.

I think that it would be inappropriate to make a judgment about the investment incentives in terms of the income distribution of the direct recipients, or even possibly in terms of the ultimate recipients, but when the subsidy is to a particular group, then it should be clear we should choose subsidies that are more efficient means of serving that group, and we should choose a procedure by which it is likely to get more visibility.

I did not imply that off budget activities get no review in Congress and the administration, but I think there is reason to believe that they get somewhat less attention than budget activities itself. It is not an either/or matter, but a more-or-less matter. I would favor a process that leads to somewhat more visible attention to the nature and magnitude of these subsidies.

Senator ZORINSKY. We have just spent a week, and we are probably going to spend another week, and maybe a few more weeks discussing the taxing proposals, in order to reduce the deficit in the budget.

The bottom line being, by this administration, or any economist, that money either flows into the Treasury or it does not flow into the Treasury. I can assure you that the debate that has been going on until the wee hours of the morning here in the Congress, I do not know how much you keep track of it, but if you do not, you should. It is going to affect your pocketbook to alter the budget, up and down. The only way you can do that is to take money from people, or let people keep money. Animals do not generate taxes. People generate taxes.

Investment tax credits, and all of these incentives, we have the private sector to initiate their ability to expand, and do those things that the private sector do, are moneys that do not go into the Treasury, obviously. They are used for other purposes, as you pointed out.

But still the bottom line is that the Treasury does not have the available use of that money, and it is denied the use of that money, and it does not receive that money in the form of taxes, and therefore it is not offset as a differential against the deficit of this budget.

So a dollar is a dollar regardless of where it comes from, and the only criteria is whether you get it or you do not get it.

In your estimation, you are not getting it from REA, and you are not getting it from the private sector, regardless of what purposes that money is being used for, because the bottom final line is the differential between outlay and income, and that is what we are debating on the floor of the Senate now.

Now, we are saying we are closing tax loopholes, and this is tantamount to what you are saying is happening in the REA area. Is that something is due, that is due, is not being paid.

Well, this is philosophical in nature, and we could also say investment tax credits are a cost of the taxpayers of this country, because they are. Because the taxpayers have to offset the money that is not being generated by the nonreceipt of those moneys that are being used in rapid acceleration, and all of these investment tax credits that the private sector uses to enhance their business.

I reject that philosophy from the point of view of a dollar generated, or escaping in the private sector means just as much as foreclosing the differential on the budget deficit as does a dollar escaping anywhere else in the budget.

I would just like to take issue also with your comment in your statement that the income of farm families is so great. The USDA has indicated that the farm family income is evaluated through all income generated by a farm family. And if it was not for outside income of farm families, farm families would no longer be farm families, because they have to have money in investments in order to remain a farmer, because if that is all they could depend on they would have gone broke a long time ago.

So I think that is another cute way of government continuing to hoodwink the taxpayers and public of this country.

You know, a long time ago I learned there are three kinds of lies. The regular lie, the damn lie, and the statistics.

We can generate statistics very rapidly, and I have talked to people in the Farm Credit System, 20 percent of the farm people today are financially in deep trouble. They are very concerned. I am not saying this in a political, context.

I invite you to come into my office and spend 6 hours answering the telephone—long distance phone calls coming in from rural America. It is not put up, it is not staged, it is not an arena where cameras are going, and it is going to go away after the day closes down. It is real. I will let you read reams of letters that we are getting, and it goes beyond the farmers, it is the bankers now that are skittish. I do not want to—it is easy to create a panic in that area—but it is a lot worse economically out there than anybody east of the Potomac River is willing to admit.

I just ask of you to come to my office and listen to the phone calls coming in. We do not activate these phone calls, we do not go out looking for business of that nature. And for somebody to say the family farm income is up today, they are going broke with the family farm income being up today. It is a serious situation, and I think one that indirectly reflects on what is happening to the REA.

The REA, I might point out, was meant to serve all rural customers, not just farmers, and that is why it was not named the Farmers' Electrification Administration.

You know, you say they have accomplished their mission, and their purpose, which indicates to me that you are answering the question that I asked about 1990, and that is you do intend to phase REA out and close it down.

I submit that they have not completed and accomplished all of their original conditions, and they will not until Consolidated Edison has achieved its objectives, and does not any longer need to borrow money. You know, you think that a rural electric, once it finishes something, needs no more money.

I was on the board of the Omaha Public Power District in Omaha, NE, and they are still issuing bonds, and borrowing money, and they always will be, and so will every private enterprise continue a need for an economic infusion.

Thank you, Madam Chairman.

Senator HAWKINS. Thank you, Senator Zorinsky.

Mr. NISKANEN. Senator, I would have no reservations about the healthy viability of the REA in 1990, if they would rely on the private credit market. The issue is not the viability of the REA itself, but the question is whether there should be continued taxpayer subsidies through the services provided by this particular organization.

If they, like other kinds of organizations, can thrive, based upon private credit, so much the better.

Senator ZORINSKY. Well, you look at it as financial, and I look at it as being a viable system that is part and parcel of the existence of the country. It would be like you sitting there and telling me that all the moneys that were spent on the Interstate Highway System came out of the Treasury Department, and need to be repaid, because they were given to contractors to create a system for the country.

You know, we can dismantle a lot of things, REA, the Interstate System—one vote I wish I had back was dismantling the AT&T. Because if you keep fixing things that are not broken, essentially all of our systems will be as good as the CBO people.

Senator HAWKINS. And more costly.

Mr. HEALEY. The total REA borrowing is in excess of $32 billion. The administration is not at all proposing that that $32 billion borrowing program be cut down, or stopped. The proposal is really very simple. It is that $7.9 billion represented by the Revolving Fund, the actual amount of that Revolving Fund is a little bit bigger than that, $9.9 billion, but the forgiveness is only $7.9 billion. It is only that that $7.9 billion not be forgiven, that it be paid back, and that future REA borrowings be at closer to market rates, so that they are not subsidized by the American taxpayer. It is not at all to close down the financing. It is just to make it somewhat closer to the costs that unfortunately we all, everyone in this room, have to pay, which is the true interest cost on the borrowings that we have to make in order to finance the debt.

It really is designed to be evenhanded. It is not designed to shut down the REA Program at all.

Senator **Zorinsky**. I have been informed by people in REA that they do not even think it is handy.

Mr. **Healey**. Any of the people in the administration who worked on this, and it has gotten a lot of attention, would be happy to talk to about it.

Senator **Hawkins**. We have received a great deal of testimony in this record from these distinguished witnesses. I thank you.

I am going to recess this hearing at this time, until 11:30. I am wanted on the floor.

[Short recess.]

Senator **Hawkins**. We have before us now Rudolph Penner, the Director of the CBO.

Mr. Penner, do you have a short statement for us?

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. **Penner**. Thank you very much, Madam Chairman.

I am pleased to appear before this subcommittee today to discuss the status of the Rural Electrification and Telephone Revolving Fund of the Rural Electrification Administration. The Congressional Budget Office has analyzed the current financial status of the Fund and its prospects over the next 25 years. Our analysis deals only with the adequacy of the Fund's resources under various economic, programmatic, and legislative assumptions. We have not assessed the merits of REA's loan program or made any judgments about the appropriate long-term lending levels. My testimony covers three areas:

First, the historical background of the REA Revolving Fund.

Second, the financial status of the Fund.

Third, options for maintaining the Fund's solvency.

Some historical background is useful in understanding the Fund's current condition. Since REA's creation in the 1930's, a major objective has been to ensure that rural cooperatives would have access to the financing needed to provide utility service in rural areas. Initially, interest rates paid by borrowers varied with the Government's interest costs. In 1944, the Congress set interest rates on REA loans at 2 percent, which was slightly above the Government's cost of borrowing at that time. In 1973, the Revolving Fund was established, and the standard loan rate was set at 5 percent—this time slightly below the Government's borrowing costs. The Congress provided seed money for the Fund, by allowing principal and interest on $7.9 billion in then outstanding loans to be repaid to the Fund, instead of to the Treasury. Because the Fund is not required to pay any interest on the $7.9 billion, the interest receipts on those loans have provided continuing income for the Fund. In addition, the principal repayments have been available to make new loans. The $7.9 billion is to be repaid to the Treasury over a 25-year period, beginning in 1993.

The Fund's lending levels are set each year in an appropriation bill, with both minimum and maximum levels specified. If necessary, the Fund can borrow from the Federal Financing Bank to finance new loans, with interest set at one-eighth of 1 percent above the Treasury borrowing rate and the principal to be repaid in 30 years.

Now, 11 years after its establishment, the Fund is on a path toward insolvency. It makes about $1.1 billion in loans each year and finances about 40 percent of them by borrowing from the FFB. Virtually all of these loans are made at a 5 percent interest rate, while the Fund has borrowed from the FFB at an average rate of 11.4 percent. As a result, the Fund's interest expenses are increasing faster than its interest income. Consequently, no earnings will be generated for the repayment of the $7.9 billion owed to the Treasury.

At some point in the future, something will have to change. Either lending activity will have to be drastically reduced, or additional resources will have to be provided to the Fund. Otherwise, the Fund will default on some of its outstanding obligations to the Treasury or the FFB.

Based on CBO's current economic assumptions, we have assumed that the Fund would borrow from the FFB at an interest rate varying between 10.6 and 11.4 percent between now and the year 2010. At that borrowing rate and if loan levels are maintained at the current $1.1 billion per year with adjustments for inflation, the Fund would be unable to meet its outstanding obligations by the year 2002. If no additional resources are provided to the Fund, REA would have to make virtually no new loans beginning in 1990 in order to avoid a shutdown in 2002 and meet the Fund's obligations at least through the year 2010.

The timing of these events is very sensitive to interest rates. The Fund's difficulties will occur sooner if rates are higher, and later if rates are lower than those we have assumed. It would take a borrowing rate close to 5 percent to ensure the long-run viability of the Fund.

The Fund's problems obviously stem from the current structure of the REA loan program. Because market interest rates far exceed those charged by REA, the Fund is now a source of substantial interest subsidies to rural electric and telephone cooperatives. The gap between the 5-percent loan rate and recent borrowing rates from the FFB has eroded the Fund's capital, and this process is almost certain to continue for the foreseeable future. For example, at the beginning of fiscal year 1984, a total of $3.5 billion in REA loans was financed by borrowing from the FFB. The difference between interest received and interest paid on those loans is about $240 million a year. This loss will rise each year as borrowings increase.

Under these circumstances, if the Congress wishes to maintain REA's loan program, it has two basic options to ensure the Fund's solvency. It can provide additional Federal resources to the Fund to pay for its continuing losses, or it can increase payments to the Fund from borrowers by raising interest rates.

If interest rates are not high enough to make the Fund self-supporting, the Government will have to provide some form of subsidy. Federal funds can be used to cover REA losses in a number of ways, including annual appropriations or less frequent, but larger infusions of funds. However, as long as lending rates remain at 5 percent, the Fund will remain a distributor of subsidies, and the

Congress must choose the mechanism to pay for those subsidies. The Fund cannot be self-sufficient under these circumstances.

From a budgetary point of view, it is desirable that the subsidy cost of an activity be explicitly recognized in the budget, at a time when the cost is still controllable—that is, before the Funds are committed to the recipient. This suggests that a preferred means of providing subsidy funds would be through an annual appropriation to cover interest subsidies implicit in the loans to be obligated in the current year. A recent CBO report, "New Approaches to the Budgetary Treatment of Federal Credit Assistance," includes several procedures that would achieve this result.

A number of other mechanisms are also available for providing additional resources to the Fund. Some of them, however, are neither explicit nor timely, and thus limit the Congress' ability to make informed decisions about the subsidy amounts. These include, for example, the conversion of Treasury debt to equity; interest-free loans to the Fund; or the shifting of interest losses to the FFB by permitting the Fund to refinance its debt if interest rates drop. Such hidden subsidies hinder congressional oversight and budgetary control over lending programs by obscuring the true cost to the Government. These mechanisms may also be of limited use to the Fund. For example, converting the $7.9 billion liability to equity would not, by itself, enable the Fund to meet its obligations. As another example, allowing the Fund to refinance when market rates fall would provide the greatest benefits to the Fund when its needs would be least—that is, when interest rates were low—and the smallest benefits when its needs would be greatest.

All these options would result in costs to the Federal Government. While they would differ in their effects on the unified budget, they would all increase the Federal deficit and the public debt at some point in the future by making it possible for REA to maintain its lending activity. This would increase Federal outlays over the level that would otherwise occur.

The major alternative to ongoing subsidization of the Revolving Fund is to change the interest rates charged to borrowers—currently 5 percent for most loans and 2 percent for hardship and certain other special cases. A return to the original policy of charging the Government's cost of borrowing would eliminate losses on future loans, though losses on outstanding loans would continue. Because the Fund has the use of $7.9 billion in capital at no interest cost, such an increase in interest rates would generate sufficient earnings to compensate for past losses and to pay the $7.9 billion owed to the Treasury. This could be accomplished even if, in special cases, a portion of the loans were made at less than Government's cost.

S. 1300, now before this subcommittee, represents one combination of these different approaches. Under the bill, the interest rate on loans to cooperatives for a given year would be set to cover the average interest cost of the REA funds used to finance those loans. The Federal Government would provide capital by forgiving the Fund's obligation to repay the $7.9 billion owed to the Treasury, and by allowing REA to refinance its outstanding borrowings from the FFB if current interest rates fall 1 percent below the rate on those notes.

Repealing the Fund's liability to the Treasury would increase the amount of funds available for loans to cooperatives. It would also have the effect of moderating the increase in interest rates paid by borrowers under this bill, because it would increase the interest-free capital in the REA Fund. Under the interest rate formula in the bill, this would reduce the average interest cost associated with any year's loans.

The provision allowing the Fund to refinance its FFB borrowings would have relatively little impact under the CBO assumptions, because our assumed interest rates would not trigger much refinancing. Greater savings to the Fund would occur if interest rates are lower. For example, if future Treasury rates were assumed to be about 6 percent, the Fund's interest payments to the FFB would be reduced by an additional $4 billion.

The resources provided by S. 1300 would enable the Fund to maintain current lending levels in real terms over the 1985-2010 period. The bill would raise interest charged to the Fund's borrowers, but the rates would remain below projected FFB borrowing costs. This would increase the Fund's receipts, but, under our economic assumptions, the Fund's interest expenses would overtake its interest income before the year 2010. Thus, the Fund would need another infusion of resources at some point in the future, because these interest losses would erode the Fund's assets.

In total, under CBO's economic assumptions, the bill would increase the combined on- and off-budget deficits by a total of $10.4 billion over the 1985-2010 period—by providing the resources for REA to maintain its current lending levels, adjusted for inflation, throughout the period.

Madam Chairman, this concludes my statement this morning. More details on this analysis appear in CBO's cost estimate of S. 1300.[1]

I will be happy to answer any questions you or the members of the subcommittee may have.

Senator HAWKINS. Some believe that this bill would create no additional costs to the Government.

With your responsibility for keeping track of the entire Federal budget, we thank you for taking the time to come before the subcommittee.

Some people are saying S. 1300 would create no additional cost to the Government is that because there is a cost already built in under current law. How true is this?

Mr. PENNER. Well, I think there are different ways of looking at it, Madam Chairman. I think obviously if you do nothing that prevents the REA from lending after the early 1990's, according to our assumptions, if it is not lending, that obviously saves some resources for the Federal Government and for the economy as a whole.

So to the extent that this bill allows the lending to go onward, obviously it is costly. It has some costs and the question is whether the benefits are worth the costs.

There are clearly other ways of conveying resources to the Fund than this particular bill and I mentioned some of them.

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[1] See p. 253 for a reprint of the CBO analysis of the budget impact of S. 1300.

Senator HAWKINS. Have any of the loan programs ever enjoyed a downward only financing provision, to your memory?

Mr. PENNER. None that I know of that are associated with the FFB. Indeed, I am hard pressed to think of any that have that one-sided risk at all.

There are programs often that do take some interest rate risk. Sometimes they go the other way. For example, various housing tandem plans that we have had in the past will cause a lot of interest rates go up in the future but will not be used—will not be drawn down if interest rates go down. So that is an assymetrical risk. But I cannot think immediately of any of exactly this type.

Senator HAWKINS. Your report states that passage of S. 1300 would not prevent insolvency of the REA Revolving Funds but merely delays the time when the Fund would run out of money.

Can you tell us how long passage of S. 1300 would delay the point of zero balance to the Fund?

Mr. PENNER. One of the problems with all of these estimates, Madam Chairman, is that they are extraordinarily sensitive to the interest rates that you assume. Given the rather high, frankly, interest rates that we are assuming in our own baseline right now, it puts it beyond 2010. So we are not so good at forecasting interest rates next month. But 2010 is extremely difficult. But certainly, given those interest rates it allows the Fund to remain viable through 2010.

Senator HAWKINS. Do you agree with the statement that there is no forgiveness involved in this bill and it merely transfers $7.9 billion from one Government account to another Government account?

Mr. PENNER. Well, I think in the technical sense obviously there is a forgiveness in the sense that the REA had an agreement to repay the loan from the Treasury at a certain—according to a certain time schedule.

Now, making—relieving them of that obligation allows them to continue lending for a longer period than they would otherwise, so it is a substitute for some other way of financing the REA and in that sense obviously it has a cost. It is complicated to find that cost but it is there.

Senator HAWKINS. Could you describe the relationship between the Revolving Fund and the FFB?

Mr. PENNER. I think the simplest way to put it, really, is that the Revolving Fund borrows money from the FFB. It borrows it by selling certificates of beneficial ownership.

Senator HAWKINS. In your opinion, what is the best way to structure a loan subsidy program?

Mr. PENNER. Well, as I said, Madam Chairman, CBO has recently reported on that and we have a variety of options. The goal of all of the options is to make the subsidy clearer.

As I said in my testimony, when you are subsidizing loans, it is desirable to put the subsidy on the books before the loan decisions are made. In other words, prospectively rather than retroactively.

We have a variety of ways of doing it, some of which are quite radical, others which require only minor accounting changes. More generally though it would not solve the problem of making loan subsidies exactly comparable on our books to outright grants for other forms of aid. We have on various occasions supported legislation to bring the FFB on budget, which in our view would help identify at least the total lending activity of the Government.

Senator **Hawkins**. Considering the controversy that exists as to which segment of the electric utility industry, whether co-ops, IOU's, or public utilities, receives the most assistance from the Federal Government; does CBO have any information or thought to shed light on this issue? And, as a minimum, does the need exist to examine whether all segments of the electric utility industry have a need for continuing Federal assistance?

Mr. **Penner**. We have not looked at that issue at all, Madam Chairman.

I think that one way to look at it would simply be to look at the cost of capital facting these various types of organizations and that is something that we can make an estimate of.

Senator **Hawkins**. Senator Zorinsky.

Senator **Zorinsky**. Thank you, Madam Chairman.

If S. 1300 is not enacted and Congress wanted to maintain the REA Loan Program under the current law and existing loan levels, how much money would have to be appropriated into the Fund between 1985 and 2010?

Mr. **Penner**. We do not have an estimate of that because the number is extraordinarily sensitive again to the interest rate assumptions and the exact time pattern of the contributions that the Congress would make.

If you would like us to work with your staff, with various assumptions about just how that pattern might be worked out, we could then provide some sort of cost estimate.

Senator **Zorinsky**. Fine. Would you please do that for the record?

Mr. **Penner**. That we can do.

[The following response was submitted by Mr. Penner for the record:]

If the Congress wanted to maintain current lending levels (adjusted for inflation) and the current loan interest rate (5 percent) without making other changes in the loan program, appropriations would be necessary to cover the fund's losses. The appropriations necessary to maintain the program would depend on the timing and method of appropriations. The earlier appropriations were provided, the greater would be the impact on the fund and the less the required funding in the long term. Thus, appropriations to cover losses in advance would be less, over time, than appropriations to cover losses after they occurred. For example, if appropriations were made using the formula applied for the 1984 appropriation (which covered losses incurred in 1982 and included imputed interest costs as an expense), appropriations over the 1985–2010 period would total about $13 billion under the baseline economic assumptions. If the Congress immediately appropriated funds to cover the estimated interest losses on existing CBOs and if annual appropriations for the losses on future CBOs were provided, appropriations could be reduced to about $10 billion. Alternatively, if funds were provided only when aggregate interest income was less than interest expense, the appropriations would total $17 billion over the 1985–2010 period.

If Treasury borrowing rates were lower than those assumed in the baseline, the amounts appropriated would be lower. Higher interest rates would increase the amounts appropriated. Appropriations would also be very sensitive to the interest rate paid by borrowers. For example, if borrowers paid interest at the average rate estimated under S. 1300 (about 8 percent), it would be necessary to appropriate only $4 billion over the 1985–2010 period.

Senator **Zorinsky**. Also, I assume to arrive at the numbers we are using as to the cost factors involved, if the program continues as it is now, you have assumed some interest factors projected into the future.

Mr. PENNER. That is correct.

The interest rate assumptions are——

Senator ZORINSKY. Now, we do like they usually do up here, use ones that reflect more advantageously to your views on one side of the coin than you do on the other?

Mr. PENNER. We have no views on that because what we use here are the interest rate assumptions used in what we call our baseline. They are the same, they are the same interest rate assumptions used to cost out any program involving——

Senator ZORINSKY. That you will be using the same factors for this as you do for the ones we have been discussing as to the cost of the program?

Mr. PENNER. That is absolutely right, or for the cost of any other program as well.

Senator ZORINSKY. Then this would be relatively simple to do?

Mr. PENNER. Yes.

Senator ZORINSKY. Thank you.

I would just like to read into the record, Madam Chairman, from a page E-18, the budget for fiscal year 1984 presented to the Congress by the administration. This is an interesting paragraph. It says:

"The Treasury supplies capital to business * * *"

It is an explanation of what we have been talking about as to the cost involved.

"The Treasury supplies capital to business-type Government enterprises in return for both capital stock and debt. The debt is shown as borrowing from Treasury on the statements of financial condition for enterprises in the budget appendix. However, the equity and the debt instruments are the same in substance and it would be double counting to add together the agency borrowing from the Treasury and the Treasury borrowing from the public that was necessary to provide the agencies with this capital.

"Therefore, agency borrowing from Treasury is excluded from the figures on agency borrowing and debt and from the discussion of this subject, both in this special analysis and in all other parts of the budget document."

I think this maybe clarifies the situation with regard as to how the administration looks at this proposal.

That is all the questions I have.

Senator HAWKINS. Thank you.

Thank you, Mr. Penner.

[Questions submitted by Senator Huddleston to Mr. Penner and answers thereto:]

Question 1. During an earlier hearing on this legislation, an Administration witness repeatedly stated that the cost of S. 1300 will be $21 billion. In addition, that witness indicated that CBO and GAO were developing new cost estimates that would support his estimate. Do you have any such cost estimates?

Answer. On April 12, 1984, CBO transmitted to the Subcommittee a new estimate of the budgetary effects of S. 1300 using the economic assumptions underlying the CBO baseline projections for fiscal year 1985. Under these assumptions, enactment of S. 1300 would increase federal outlays by an estimated $10.4 billion over the 1985–2010 period. The differences between the new CBO estimate and the analysis submitted to the Subcommittee on October 14, 1983 result primarily from differences in the economic assumptions.

Question 2. In your statement, you indicate that S. 1300 will not ensure the solvency of the REA revolving fund. Could the solvency of the fund be ensured by including in the bill a provision—such as the amendment offered by Congressman Stenholm to H.R. 3050—that explicitly mandates that the interest rate formula be set so that interest income will equal interest expense?

Answer. With the interest rates and lending levels assumed and the method used in CBO's analysis, adding the Stenholm amendment to S. 1300 would maintain the fund's solvency through the year 2010. But enactment of the amendment might not ensure permanent solvency. (CBO considers the fund solvent if it has a net worth greater than or at least equal to zero.)

As introduced, S. 1300 would enable the fund to maintain its current lending levels adjusted for inflation through the year 2010. It would not ensure solvency, however, because the interest-rate formula uses all of the fund's net income to subsidize the interest rate on future loans. As a result, the fund's net worth would gradually be eroded, and ultimately, the interest-rate formula would produce standard rates above the Treasury borrowing rate.

The Stenholm amendment to H.R. 3050 seeks to address these problems by requiring that the interest rate on REA loans be sufficient to produce total interest income equal to the interest expense on the fund's past and future obligations. The amendment does not specify how the REA Administrator should set rates to accomplish this.

CBO has analyzed the effect of the Stenholm amendment using two different approaches. One approach assumes that the Administrator would impose a surcharge on loans when the balance between the fund's interest expense and interest income requires an infusion of money. The second approach assumes that the Administrator would impose a surcharge beginning in 1985. In both cases, CBO's estimate assumes that the standard rate would be set so that the interest payments from the 35-year, amortized loans will equal the interest payments on the 30-year, non-amoritzed obligations to the FFB.

Because of the higher interest paid by borrowers, including the Stenholm amendment would reduce the budgetary effects of S. 1300. The amount of the reduction would depend on how the amendment was implemented. Under the first approach, CBO estimates that enactment of S. 1300 with the amendment would increase net federal outlays by about $10.2 billion over the 1985–2010 period. Under the second approach, net federal outlays would increase by an estimated $8.9 billion through the year 2010. These outlay estimates reflect the difference between applying a surcharge late in the period and applying it starting in 1985.

Under CBO's methods and assumptions the fund would remain solvent through the year 2010 if the Stenholm amendment were included in the bill. Because the standard rate might still exceed the Treasury rate in the more distant future, this amendment might not ensure the permanent solvency of the fund.

There is more than one way, however, to interpret the standard interest rate formula in the bill—and the REA and the National Rural Electric Cooperatives Association (NRECA) generally use a method that produces a rate lower than emerges from the CBO analysis. When such a lower rate is assumed, the fund's interest income is less, and the fund would not remain solvent through the year 2010—with or without the Stenholm amendment. The fund would, however, be able to continue its lending activity throughout the period.

Senator **Hawkins**. John Luke, the Associate Director, Resources, Community and Economic Development Division, U.S. General Accounting Office will be our next witness.

STATEMENT OF JOHN LUKE, ASSOCIATE DIRECTOR, RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY ROBERT EDWARD ALLEN, SENIOR GROUP DIRECTOR, AND THOMAS STORM, SENIOR GAO EVALUATOR

Mr. **Luke**. Madam Chairman, I have with me, to my left, Ed Allen, who is our Group Director responsible for the audit work that we conducted, and to my right is Tom Storm, our resident expert in the area of REA and the one actively involved in the conduct and leadership of most of the work that we have done in this area in the past.

I will provide a brief summary of my statement, and I would like to submit my detailed statement for the record.[1]

Senator **Hawkins**. That would be fine.

Mr. **Luke**. Madam Chairman, Senator Zorinsky, we are pleased to be here today to discuss our work on the integrity of the Rural Electrification and Telephone Revolving Fund and to provide you with your comments on Senate bill S. 1300, the Rural Electrification and Telphone Revolving Fund Self-Sufficiency Act.

As you know, the financial position of the Rural Electrification and Telephone Revolving Fund, established in 1973 and administered by the Rural Electrification Administration, REA, is eroding. For year, the Fund's income has been insufficient to fund new loans so the Fund has been borrowing from the Federal Financing Bank at interest rates substantially higher than the 5 percent interest rate charged on REA loans financed from the Fund. As a result, the Fund's interest expenses will exceed interest income in 1986, and the Fund will need appropriations by 2002 to continue operation unless relief is provided. Senate bill S. 1300 would attempt to balance the Fund, that is, make it self-sufficient by changing the basis for setting interest rates on REA loans, and reducing the Fund's future cash payments by permanently capitalizing the Fund's $7.9 billion Treasury debt and authorizing the Fund to refinance at reduced interest rates its borrowings from the Federal Financing Bank.

You requested us to look into the size of subsidies provided to various segments of the electric utility industry and their effect on electric rates, the effect of REA loan subsidies on the Revolving Fund, and the impact of S. 1300 on balancing the Fund.

SUBSIDIES TO ELECTRIC UTILITIES

As shown in exhibit A, rural electric cooperatives receive sizable subsidies through REA's 5 percent interest rate loans—about $404 million, present value, for every $850 million in REA loans.

Investor-owned utilities and public utilities also receive subsidies in the form of tax benefits but, as exhibit A shows, the loan subsidies provided to cooperatives is 2.4 times greater than the subsidies provided to investor-owned utilities and 1.4 times those provided to public utilities for a comparable level of financing.

The loan subsidies provided to cooperatives helps reduce electric rates by almost 7 percent whereas the subsidies to investor-owned utilities reduce electric rates by only about 3 percent.

Cooperatives also do not pay Federal income taxes or loan fees to cover REA's administrative expenses. In addition, they purchase power from Federal agencies on a preferential basis, as do public utilities.

STATUS OF REVOLVING FUND

REA loan subsidies have not yet produced an unfunded liability in the Revolving Fund. As exhibit B shows, the Fund's future receipts from present loans is sufficient to cover all future payments, including the $7.9 billion owed the Treasury.

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[1] See p. 261 for the detailed statement submitted by Mr. Luke.

Exhibit B also shows that the Fund now has a net equity of $1.6 billion, present value, which will enable the Fund to operate at present loan and subsidy levels for about 3.5 years at which time an unfunded liability would begin to accrue in the Fund.

Despite the Fund's net equity, exhibit B shows that the subsidies on REA loans financed through the Fund have cost the taxpayers $8.2 billion, present value. This is because the Fund's net equity is insufficient to cover the interest that was waived on the $7.9 billion the Fund owes to the Treasury.

LOAN INTEREST RATES UNDER S. 1300

Section 6(1) of S. 1300 would replace the present 5 percent interest rate with a formula for setting rates. Exhibit C illustrates how this formula would work to set the rate. Although the formula should produce higher interest rates than the present 5 percent, these rates will not make the Fund self-sufficient. For example, an interest rate of about 8.4 percent would be needed to balance the Fund assuming the Government's cost of borrowing remains at 11 percent; program lending remains at the current level of about $1.1 billion; and sections 4 and 5 of S. 1300 are not put into law.

In contrast, the imterest rate formula in this bill would result in an average interest rate of only 7.8 percent under the same assumptions, a rate that would be insufficient to balance the Fund.

The formula does not work in this or most other situations because the interest rates produced by the formula are not adequate to generate sufficient interest income to cover interest expenses. In addition, the formula makes no provision for retiring the Fund's debts with the Federal Financing Bank. As a result, the Fund has to borrow larger amounts from the Federal Financing Bank than would otherwise be necessary and, eventually, the loans used to secure these debts become exhausted, making appropriations necessary.

The section 6(1) formula also would continue Federal subsidies. This is because the formula erroneously presumes that the Fund's loan receipts, because they are assets of the Fund, carry a zero interest cost when they are reloaned. But, in reality, these loan receipts have a value equal to the Government's cost of money—borrowing. This is because the reuse of loan receipts to make new loans deprives the Government of the use of these funds; funds that the Treasury could use to reduce its borrowings. Consequently, as long as REA loan interest rates are less than the Government's cost of borrowing, a subsidy will exist.

Although subsidies would be reduced from their present levels under S. 1300, are subsidies needed and, if so, what should be the appropriate level of subsidy? In our report on the "Rural Electrification Administration Loans to Electric Distribution Systems: Policy Changes Needed" (CED-80-52, May 30, 1980), we reported that:

Many cooperatives appear financially sound and able to qualify for non-REA loans at reasonable rates and terms. Further, some could do so and still charge electric rates comparable to those charged by neighboring investor-owned utilities.

REA needs to do more to help cooperatives that do not now have the financial strength to borrow from non-Federal sources to become self-sufficient.

REA's loan making criteria does not adequately correlate the type and/or amount of subsidized loan with the borrowers' needs.

In a May 1983 audit report, the Department of Agriculture's Office of Inspector General confirmed what we had found in our May 1980 report; namely that cooperatives were receiving REA assistance regardless of financial need. The Inspector General also reported that cooperatives were receiving REA assistance regardless of whether they were still servicing rural areas. According to its report, REA and the Department of Agriculture's Office of General Counsel have interpreted the Rural Electrification Act and congressional directives to allow loans to cooperatives regardless of their financial strength or the urban/rural characteristics of their service areas.

In view of the findings in these two reports, we believe the Congress needs to reexamine and clarify the program's objectives as well as the criteria to be used to determine the level of assistance—subsidy—to be provided and the intended beneficiaries to accomplish the program's objectives.

Section 7(4) of S. 1300 would allow cooperatives to refinance without penalty REA guaranteed loans financed through the Federal Financing Bank when interest rates on new loans fall 1 percentage point or more. Similarly, section 5 would allow the Fund to refinance without penalty its debts with the Federal Financing Bank whenever the rate on new debts falls 1 percentage point or more.

These sections would permit cooperatives and the Fund to reduce their interest cost commensurate with decreases in interest rates. But neither section 5 nor 7(4) provides for increasing interest rates when rates are rising. As a result, this one-sided approach would shift some of the risk of financing to the Government. With this shift in risk, the Government could realize unexpected gains or incur unnecessary losses depending on the movement of interest rates subsequent to any refinancings. Consequently, to preclude any gains or losses to the Government, the Congress may wish to provide for charging an adjustable or variable interest rate.

As exhibit B shows, the Fund is now capable of repaying its $7.9 billion in debts to the Treasury. Yet, section 4 of the bill would permanently capitalize this debt as equity in the Revolving Fund.

If enacted, section 4 would inject the Fund with additional resources and, in turn, reduce the amount of new debt the Fund otherwise would incur and the related interest expenses thereon and, in so doing, extend the Fund's capacity to operate farther into the future. As shown in exhibit C, the Fund's interest expenses would be considered in setting loan interest rates under the formula provided in section 6(1) of the bill. Therefore, this action, together with any reductions in interest expenses made possible under section 5 of the bill, would ultimately affect loan interest rates. Consequently, the Congress may wish to consider the effects of these provisions on loan subsidies in addressing the program's objectives.

This capitalization of Treasury debt is analogous to appropriating $1 billion to the Fund today. As shown in exhibit B, the present value of this debt is about $1 billion. However, because this action would take place outside the budget/appropriations process, we believe it represents a form of backdoor financing. In the past, we have objected to similar backdoor financing schemes because they lessen the Congress' ability to control the Federal budget.

If the Congress desires to capitalize this debt, we would recommend that the budget/appropriation process be used to accomplish this. As an alternative, the Congress may wish to consider making appropriations to cover any and all loan subsidies that might result from its actions in establishing new REA loan interest rates. This could be accomplished by amending section 6(3) of the bill to require REA to request appropriations to cover all loan subsidies. As now written, section 6(3) of the bill would require REA to request appropriations to cover only those subsidies made possible through loans made at interest rates less than the standard interest rate established under the formula in section 6(1).

Regardless of whether appropriations are used to capitalize Treasury debt or Fund loan subsidies, we recommend that the Congress bring the Revolving Fund back on budget. When the Fund was established, its activities were placed off budget. We have consistently opposed off budget programs, including this one, because such programs do not have to compete for resources within the same decision framework applied to on budget programs, although such programs may be equally worthwhile.

Madam Chairman, this completes my summary, and I would be pleased to answer any questions at this time.

Senator **HAWKINS**. I apologize in advance for the jumping jack hearing, but we have a vote on now. We will go vote and then we will come back and take testimony from you and the next two panels.

[Short recess.]

Senator **ZORINSKY** [presiding]. We will call the hearing back to order, and I just have a brief question of you, Mr. Luke.

In projecting these figures as to the cost involved, you used a number of what, 11 percent interest?

Mr. **LUKE**. That is correct.

Senator **ZORINSKY**. And you are with the Congressional Budget Office?

Mr. **LUKE**. General Accounting Office.

Senator **ZORINSKY**. Yes, with the GAO.

Mr. **LUKE**. Yes.

Senator **ZORINSKY**. Why is it that in the budget that the administration gave to us in Congress the project interest figure was 8 percent as to arriving at the projected conclusions, whereas, in your projections, and I assume they are made in the same administration, you use a figure of 11 percent?

Mr. **LUKE**. First of all, we are not part of the administration.

Second, I would not want to defend the agency, to say that the agency did use it.

What we simply did was to use the cost of money to the Treasury at the time that we made our calculations, which was 11 percent, and we just assumed that figure throughout the analysis.

Senator ZORINSKY. And you think that yours is more realistic than the administration's?

Mr. LUKE. In the context of cost of money today, when we ran the analysis, yes. But, as indicated earlier in predictions of interest rates, it is extremely difficult.

Senator ZORINSKY. Then how do we get a better handle on what projection to use, or is that just a matter of assumption?

Mr. STORM. Well, Senator, if I could add to that.

I would rather go with the present 11 percent cost of money today. That is a known figure. I can live with that. There is just too much uncertainty in trying to predict what future interest rates are going to be. If I knew it could be done with any degree of accuracy, I am sure all of us could run out there and probably make a lot of money on our own.

Senator ZORINSKY. We are expected to cut a few hundred billion dollar deficits in the budget based on an 8 percent interest figure, so we are going to have to have even more faith than you have got, if what you say is true.

Mr. STORM. I appreciate your problem.

Senator ZORINSKY. Well, let me ask you this.

How long have you been in your present position?

Mr. STORM. In my present position, I have been with GAO for 15 years.

Senator ZORINSKY. Mr Luke, how long have you been?

Mr. LUKE. Eight or nine years.

Senator ZORINSKY. And you feel that all the numbers and all the values and all the hypotheses assumed are based on historical averages or occurrences rather than hypothetical guesses?

Mr. LUKE. That is correct. As a matter of fact, in our work in the General Accounting Office, we very rarely look into the future. Most of our analyses are based on some historical trend.

Senator ZORINSKY. On February 23, Senator Huddleston sent a letter to the GAO raising several questions about GAO's analysis with S. 1300, and since he did not receive a written response to that letter, on February 23, perhaps you could answer one of the questions that Senator Huddleston raised in his concern.

Could the solvency of the Fund be insured by including in the bill a provision such as the amendment offered by Congressman Stenholm to H.R. 3050, which is that explicitly mandates that the interest rate formula be set so that interest income will equal interest expense?

Mr. LUKE. Yes, Senator. We looked at the Stenholm amendment as well as the amendment to H.R. 3050 offered by Congressman Bethune, and we think either of those would do the job in terms of balancing the Fund and making it self-sufficient. But, in addition to that, I would like to point out again that we are of the opinion that we need to look at what should the subsidy be and who should receive that subsidy? I think today there is something like 920-plus REC borrowers, many of those, based on some analytical work we have done, are financially sound. The question becomes should they or should they not become the recipients of REA loans?

Mr. STORM. Senator, I might add, so as not to give you the wrong impression, that we do appreciate the job that the cooperatives have done. In our May report and our statement, I think we well recognize that there are some co-ops out there that still are financially weak, and some of them have high electric rates, and we think if the Congress were to do what we suggest, that is, look at the objectives of the programs and the subsidies, it is possible that for some co-ops, we might come to the conclusion that they need a greater subsidy than they have received in the past in order to make things better and easier for rural Americans out there.

Senator ZORINSKY. Thank you for your objective views.

I am especially pleased to get the answer for Senator Huddleston on his concern also.

Excuse me. Is there a staff person here from Senator Hawkins? Do you know if she has any questions?

The cooperatives tell us that they receive only about one-fifth as much assistance from the Federal Government as do the private utilities. And your report says to the contrary, that Federal subsidies to cooperatives are 2.4 times as large as subsidies to private utilities, even if we do not count the exemption that they get from taxes on their revenues. Preferential access to—here, finish it.

Senator HAWKINS. Preferential access to Federal power sources, or REA administrative costs.

Can you explain why your conclusions are so different from those of the co-op associations?

Mr. LUKE. Yes, Madam Chairman.

If you notice on exhibit A, it is indicated on the statement that REC's receive subsidies at the rate of 2.4 times that of IOU's and on the order of 1.4 times that of public utilities. I think the difference may be in the way the calculation was made.

In our own calculations, we looked at the entire life cycle of the program, granting $850 million in capital outlays. It appears to me that the cooperatives may have looked at the subsidy cost only in the first year.

Tom.

Mr. STORM. I think basically that pretty well explains it. We did limit the program, to $850 million. The co-ops use that same figure in a report on financing co-ops for the future.

To put this in proper perspective in terms of the impact on the Revolving Fund, we assumed that $850 million would likewise be borrowed by the public utilities and investor-owned utilities. That way we were assuring that we were comparing like items, and we did use the life cycle cost to determine the subsidy cost in present value terms, which was something that was not done in the co-op analysis. The co-op's analysis looked at first year subsidy costs.

Senator HAWKINS. Do you believe that the method proposed in S. 1300 of financing the co-ops' growing capital cost through forgiveness of the Revolving Fund, $7.9 billion test of the Treasury is the most effective method?

Mr. LUKE. As I indicated in my statement, no, we do not.

As we pointed out, currently under present value terms, the Fund is capable of repaying the Treasury debt today and, in doing so, still would have a net equity of $1.6 billion. We think that the most appropriate way to address this is to identify what the subsidy should be and who should be the recipient of those subsidies.

Senator HAWKINS. What is your opinion of forgiving the $3.4 billion in outstanding CBO's, instead of the $7.9 billion in the Revolving Fund?

Mr. STORM. Well, the bill really does not provide for forgiving the $3.4 billion in CBO's. We really have not considered to what extent, if you forgave that, it would help out the Fund. If you forgave the debt alone, we presume that you would be forgiving the interest on that debt as well, and it is not something that is in the bill, so we have not looked at it.

Senator HAWKINS. Is it the interest on the CBO's that is dissipating in the Revolving Fund?

Mr. LUKE. I think our position would be that it's not so much the interest on the CBO's as it is a function of the Fund's borrowing and lending. It is borrowing on the one hand from the Federal Financing Bank at much higher interest rates than what it's lending at. And that subsidy over time has eroded the Fund and after a period of time it catches up with you.

Senator HAWKINS. In your opinion, how much of the funds could the Co-op Finance Corporation, or other funding sources make available to REA cooperatives to borrow?

Mr. STORM. We really do not have any data on that. I believe the Cooperative Finance Corporation does go out and borrow in the private market. To what extent they would be limited to raise capital for the co-ops, I am really not prepared to respond.

Maybe the gentleman that is going to be here later from Lehman Bros. might be able to give you a better assessment of that.

Senator HAWKINS. Rate comparability between co-ops and the adjacent IOU's has always been a justification for the program.

Does not your exhibit E and your testimony indicate that there are 257 financially sound cooperatives which have residential rates lower than the average IOU residential rate?

Mr. LUKE. That is right.

Mr. STORM. That was true in 1981. The data in our exhibit, in our statement, pertains to 1981. Those numbers may have changed, if you look at 1982 or 1983. But, I still think it is true that we have some financially sound co-ops out there that are charging lower rates.

Senator HAWKINS. If demands on the Revolving Fund were lessened immediately, such as by allowing the financially strong co-ops, or those with extremely low residential rates, or those which serve predominantly urban or large industrial areas to secure greater outside financing, according to their own ability, would this assist in helping to make the Fund more stable?

Mr. LUKE. Again, we think so. As indicated earlier, as long as all co-ops borrow from the Fund, there are a number of those that would be sound. In addition, there are some that are no longer serving rural areas, and we think there is a negative correlation between reducing that population and the dollar value of that subsidy.

Mr. STORM. Madam Chairman, I would point out that by eliminating some financially sound co-ops from assistance, overall we would reduce the demand for money from the Federal Government, which in the long run would probably reduce subsidy costs. But if we stick with $850 million in program loans each year, you would still be continuing subsidies at the current level. It is just that it would be spread among fewer co-ops.

Senator HAWKINS. Your May 1980 report was critical of the density criteria used to determine the eligibility of the REA's 2 percent interest rate loan. Because section 6 of S. 1300 would use the same density criteria to determine eligibility for special low-interest loans, could you tell us why GAO objected to the use of the density criteria?

Mr. ALLEN. Yes, ma'am; I could answer that best by quoting some statistics from our report.

For the borrowers we reviewed, with respect to our report, we reported that 52 percent of them charge lower electric rates than the neighboring IOU's. In contrast, 61 percent of the 2-percent borrowers have lower charges.

We also reported that 26 percent of those with lower rates received 2-percent loans, whereas 31 percent of those with higher rates also received 2-percent loans. You would think the borrowers with higher rates would be in greater need of the 2-percent loans, but these statistics do not seem to indicate that. Because 74 percent of the borrowers had qualified for the 2-percent loans solely on the basis of the density criteria and not financial need, we concluded that it was not a good test.

Senator HAWKINS. Your May 1980 report was also critical of REA's use of plant revenue ratios to determine the portion of a borrower's loan needs that could be met with an REA loan, or the level of financing to be obtained from other sources.

Could you expand on this, and is REA still using this ratio, to your knowledge?

Mr. ALLEN. Yes ma'am, REA is still using this ratio. It represents the ratio of a plant's total costs to its revenue during a given period of time. REA uses the ratio to determine whether it will provide a 5-percent loan at a 70-, 80-, or 90-percent level of a particular borrower's loan needs.

In our report, we stated that the ratio does not provide a very good correlation between the subsidies provided to borrowers and the borrower's needs for this assistance if it is to charge electric rates comparable to neighboring IOU's.

Senator HAWKINS. Is it true that the capitalization of Treasury debt as provided for in section 4 of this bill will not have any effect on the Federal budget?

Mr. LUKE. The capitalization of the Treasury debt has the effect of providing another interest-free loan. By reducing the Fund's interest expenses, it allows REA to charge lower loan interest rates under this formula in an effort to match the Fund's interest income to its reduced interest expenses.

However, these lower loan interest rates only increase the cost of the Government subsidy that is reflected in the Treasury outlays and the budget deficit.

In all, the capitalization of this Treasury debt would have the effect of increasing REA subsidies, Treasury's net outlays, and the budget deficit.

Senator HAWKINS. I will have more questions later.

Senator Zorinsky.

Senator **Zorinsky**. There is no needs test for subsidies for investor-owned utilities. So why should there be for rural electrics?

Mr. **Storm**. Given that some cooperatives are financially strong, charge rates lower than their neighboring IOU's, and are now involved in providing power to some suburban areas, we basically believe it is a time to examine what the objectives are of the program, and where it is that we want to go. I am sure the Congress, in its wisdom, will hopefully be able to resolve this particular issue.

Senator **Zorinsky**. Are there not any investor-owned utilities that are strong?

Mr. **Storm**. Yes; there are financially strong investor-owned utilities. I would point out that we certainly advocate that the Congress in all of its Federal programs, should periodically reexamine the amount of assistance that is being provided, and whether there is a need for that. In effect, it might be appropriate at times, or on occasions, to look at what we are doing in terms of the IOU's.

Senator **Zorinsky**. We keep comparing the IOU's with the REA, except when we do not want it to reflect in the opposite direction. That is why, I think, you know, that you are going to use the investor-owned utilities as a standard to which you want to bring REA's, IOU's growth subsidies is five times as high as rural electrics.

Maybe we ought to try to bring rural electrics up to IOU's.

Mr. **Storm**. Well, the information we presented on the differences in subsidies was provided in an attempt to respond to the chairman's request. Personally, I do not think we ought to be comparing what IOU's are doing with respect to public utilities or coops. I think that the need for subsidies and assistance should be looked at with respect to the particular entity or activity that we are talking about, and if the need for subsidies can stand on its own, then we go ahead and provide them. If it cannot, then we cut back.

Senator **Zorinsky**. Is this not exactly what happens, inasmuch as the REA Administrator is the one that makes the decision with respect to low-interest loans, or the special low-interest loans?

Mr. **Storm**. The special low-interest-rate loans.

Senator **Zorinsky**. That is all the questions I have.

Senator **Hawkins**. Has the GAO determined what needs to be done to produce interest rates sufficient to balance the Fund?

Mr. **Luke**. We did not make any independent analysis as to what may be appropriate with respect to a specific interest rate. However, I may point out that we did review REA's analysis, and the application of the formula, and its computer program, as well. Further, in terms of the interest rates needed to make the Fund self-sufficient, we did look at the amendments offered by Congressmen Stenholm and Bethune, and we think that those would do the job of making the Fund self-sufficient. I think on an independent basis that was the extent of our knowledge with respect to interest rates.

Mr. **Storm**. May I add two little points to that?

We were not as concerned as much about balancing the Fund as we are about looking at the need for the subsidies. I think once this issue is addressed, then it would be appropriate to look at what would be the best means of, or mechanism, to structure and fund the assistance we decide that we want to provide.

I would also like to comment that there are several aspects of the Bethune bill that we found very good. Basically, it would require the amortization of CBO's. It would eliminate the density criteria in providing loans at special interest rates. It would require REA to encourage borrowers to become financially sound so that they could obtain more of their credit needs from other sources. It would give REA the authority to request applicants to obtain more of their credit needs from other sources as their financial strength increases. In addition, it would require the REA to return to the Treasury all amounts received from the redemption or retirement of capital stock in the Rural Telephone Bank. We think these are all commendable features, and they do go along with the thrust of our testimony.

Senator HAWKINS. Based on the subsidy shown in exhibit A, could you tell us what these subsidies amount to, on a consumer-served basis?

Mr. STORM. We have broken that down on a consumer-served basis, and basically it comes out to about $2.35 per consumer for investor-owned utilities, $21.93 per consumer for public utilities, and about $41.04 per consumer for cooperatives.

Senator HAWKINS. If subsidies were appropriated, as GAO suggests, how do you envision this would work?

Mr. STORM. OK. Basically, we would envision that, if you appropriated the subsidies, REA, in effect, would take the subsidies and use it to buy down the actual interest rate on the funds that they would need to borrow from the Federal Financing Bank to finance the loans.

Senator HAWKINS. Could you explain how the matrix in exhibit F could be used to determine the appropriations that would be needed to buy down loan interest rates?

Mr. STORM. As exhibit F shows, right now with an 11 percent cost of money and 5 percent REA loan interest rate, you need about 47 cents for each dollar that you advance to buy down the loan interest rate. Consequently, to finance a $1.1 billion program, which is the REA Electric and Telephone Program together, an appropriation of $523 million would be needed. With such an appropriation, you could buy down that 11 percent interest rate to 5 percent. You could make all loans at 5 percent, and we would be paying the FFB 5 percent. That is basically how we see it would work.

Senator HAWKINS. I have a question by Senator Huddleston, who could not be with us today.

On February 23 he sent a letter to GAO——

Senator ZORINSKY. I have already done that.

Senator HAWKINS. Have you done that? Good.

I believe you said in your testimony that you reviewed the Stenholm amendment?

Mr. LUKE. That is correct.

Senator HAWKINS. If you could start the REA Program all over again, what would you do differently?

Mr. LUKE. I could think of two things offhand. Again, the point Tom made earlier, with respect to the identification of what segments of the population needs the subsidy, and what should that subsidy be.

Second, make some provisions with respect to CBO's and the $7.9 billion in Treasury debt for the repayment of these debts. As it is right now, and as reflected in S. 1300, there are no provisions at all with respect to retiring those debts. I think that is essential with respect to any obligations that the Fund incurs.

Senator HAWKINS. When a rural electric starts out, it is very rural and dense, like in Fort Myers, FL, it becomes more urban, with 80,000 customers in a small area.

Do you think there should be two programs—one for rural and another for urban?

Mr. STORM. That would be appropriate, especially if those co-ops were financially sound, and were able to buy the electricity at rates comparable to neighboring IOU's. You could take those out.

But on the other hand, there are co-ops that do have high rates, and do not have quite that strength, that do need assistance. Some of it goes back to density, but yet density is not a sole factor. We just have a problem of putting too much weight on density because 70 percent approximately of your cost of operation is for cost of power. It is not so much the interest on the loan this is a problem, it is the cost of the power. Up in the Northwest, you have many co-ops that can take advantage of low cost hydroelectric power. Although they may have a low density rate, the low cost of power can offset the cost of serving low density areas. So you have a mixed bag. It is complicated, and you need to consider a number of factors.

Senator HAWKINS. We appreciate you gentlemen joining us today, and your testimony is very enlightening, as are your reports. We appreciate it very much.

Thank you for being here today.

The next panel will consist of Rex Carpenter, general manager, Nebraska Rural Electric Association, Lincoln, NE; Lester Murphy, Jr., executive vice president, Kansas Electric Cooperatives, Inc., Topeka, KS; and James M. Hubbard, executive vice president, North Carolina Association of Electric Cooperatives, Raleigh, NC.

Mr. Carpenter.

Senator ZORINSKY. Madam Chairman, I apologize, I am going to have to leave, but I wonder if I could put—ask unanimous consent to put into the record questions that I would have asked to Rex Carpenter, and answers thereto, had I been allowed, and also a statement for the record on S. 1300?

Senator HAWKINS. Surely, and the next panel also, I am just advised that we are going to be evicted in 30 minutes, anyway.

So we are going to put a lot in the record today, due to our interruptions from voting on the floor.

[Questions for Rex Carpenter from Senator Zorinsky and answers thereto:]

In your statement, you said several Nebraska systems qualified for "special interest rate" loans.

Two questions:

Question 1. What are special interest loans and how did Nebraska systems qualify for them?

Answer 1. Special interest loans are 2% interest loans for systems which meet certain economic hardship criteria. Sixteen Nebraska systems have qualified for these loans because they serve less than two consumers per mile of line. In one case, the system also has a plant/revenue ratio of more than 9.0.

Currently, about 170 of the nation's 1,000 rural electric systems meet the criteria for these special interest rate loans, but they are made only at the discretion of the REA Administrator.

Question 2. Does S. 1300 provide for these kind of loans?

Answer 2. In S. 1300, provisions are made for special interest loans which would be half of whatever the standard rate but not less than 2%. The provisions also tightened up the criteria for qualifying for a special interest rate loan. An analysis has shown that only about 60 systems would qualify under S. 1300's criteria.

We also prefer an amendment made in H.R. 3050, the House version of S. 1300, which make it mandatory for the REA Administrator to approve the special interest rate for those systems which meet the stricter criteria. I would add that these loans would be reviewed every five years to ensure that the system continue to qualify for the special interest rate.

Senator HAWKINS. Mr. Carpenter, Mr. Murphy and Mr. Hubbard, due to the lack of time, we will enter your testimony in the record as though read, and you can answer the questions that we have.[1]

How about that?

So we can get the last panel members up also, we'll try to be brief. I appreciate your coming from so far away and being with us.

As I said many times, my goal is to ensure that rural America continues to receive electric and telephone service at an affordable rate and therefore I appreciate your contribution to giving us your views from the different States.

Mr. Murphy, as you know, there is an extremely large difference among the various co-ops in their retail residential rates. A typical family of four would normally consume about a thousand kilowatt hours per month. That amount of electricity costs well over $100 in some co-ops while less than $20 in others.

For example, we have noted in Kansas there are five co-ops which have rates over $85 per thousand kilowatthours.

In your opinion, is it fair to the co-ops in Kansas which already have very high rates to allow other co-ops with very low rates the same benefits such as the 70–30 ratio when applying for loans from the Revolving Fund, especially when you heard all the testimony today as to the condition of the Fund.

PANEL CONSISTING OF REX CARPENTER, GENERAL MANAGER, NEBRASKA RURAL ELECTRIC ASSOCIATION, LINCOLN, NE; LESTER MURPHY, JR., EXECUTIVE VICE PRESIDENT, KANSAS ELECTRIC COOPERATIVES, INC., TOPEKA, KS; AND JAMES M. HUBBARD, EXECUTIVE VICE PRESIDENT, NORTH CAROLINA ASSOCIATION OF ELECTRIC COOPERATIVES, RALEIGH, NC

Mr. MURPHY. I might add that it is higher than $80-some per thousand kilowatts. We have some systems now that are over 11 cents a kilowatt. So it is extremely high rates. We have quite a variation across the State of Kansas in rates among the rural electric cooperatives, but this is governed somewhat by the power suppliers they are served by.

In western Kansas where we have the highest rates, it is because of a new plant that has come on line that has a high capital cost involvement and therefore those systems are paying higher rates. That plant however was not built of course with 5-percent money, it was built with market rate interest type of financing, so we have a significant cost involved there.

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[1] See p. 293 for the prepared statement of Mr. Carpenter; p. 296 for the prepared statement of Mr. Murphy; and p. 298 for the prepared statement of Mr. Hubbard.

Also in that area where the rates are higher, we also have the highest use. I heard this morning some talk about lower rates would encourage the waste of energy. I can assure you at 11 or 12 cents a kilowatthour, people that are irrigating crops are not wasting the energy. The reason for the high use for our rural consumers is the fact that they are so dependent upon them and it is used to improve the efficiency of their operation. And even though the electric rates are high, they are much lower than what it would cost to hire people to do those types of functions.

Senator HAWKINS. Mr. Hubbard, in North Carolina there are nine co-ops where consumers have been paying $70 per month for 1,000 kilowatthours for electricity, which may be low considering our other figures that we are given. While many other co-ops using money from the Revolving Fund have been paying significantly less for the same amount of electricity.

Do you think it is fair to those co-ops in North Carolina that they are treated the same as co-ops which are already paying far less than your co-ops?

Mr. HUBBARD. Yes; Madam Chairman, I do.

A primary reason that those cooperatives that you referred to are paying slightly more than some other cooperatives in the same State gets back to a figure you heard earlier of about 70 cents per dollar of the revenue that the consumer is paying into that cooperative having to go for the cost of the wholesale power cost and in some cases more.

We are involved in North Carolina, as we are in probably most of the other States, the 46 that are served by electric cooperatives, in trying as best we can to do something about the ever escalating costs of power to rural consumers. What we have underway in that State is a power generation plan that hopefully over time is going to eliminate some of those inequities.

I do not think they come about because of the availability of the rural electric financing program. It comes about primarily because of the terrible cost of wholesale power. As we look out into the future, the $100 that we just heard for a thousand kilowatthours is going to be much, much more.

I am concerned about some shifts that I have seen. We heard testimony a few minutes ago on 1981 comparative numbers. The shift in our State, vis-a-vis the cost between the cooperatives and the utilities is going—I would be happy to sit here and tell you that every cooperative in the State pays less for power than the investor-owned utility. I wish it were so. But the trend is rapidly in the other direction. I wish the utility costs not only for the cooperatives but the cities and the power companies was going that way. It is going rapidly the other way.

Senator HAWKINS. Do you know how much power cooperatives in North Carolina generate?

Mr. HUBBARD. We are not generating at the moment, other than in one instance, I believe, a very, very small hydro unit which has about 800 kW generating capacity.

We are involved in the construction of some generation jointly with the cities in our State and South Carolina and with Duke

Power Co. Hopefully, if the redtape can be cut; the first power out of that unit will come on line in 1985. That will be our first actual generation.

Senator **Hawkins**. Mr. Carpenter, as you know the REA Act of 1936 as amended provides loans for rural electrification and the furnishing of electrical energy to persons in rural areas who are receiving central station service and for the purpose of furnishing and improving telephone service in rural areas.

However, we have heard a lot of testimony today that many co-ops are not rural in nature any more.

For example, 5 co-ops have over 73,000 consumers on their systems and over 100 co-ops have over 20,000 consumers on their systems. And this has resulted in a consumer density of over 50 customers per mile in 4 co-ops and over 20 per mile in 13 co-ops.

Now, do you think it is fair that truly rural co-ops having less than 2,800 consumers are required to compete for the same percentage of REA funding as your larger, more urban co-ops?

Mr. **Carpenter**. Yes; because I still think, Chairman Hawkins, that by definition even if it was just for the rural systems served 50 consumers per mile, that is still far below the average where say the municipal electric systems average more than 60 consumers per mile and most investor-owned utilities.

There are few exceptional cases, very few out of nearly 1,000 electric systems have 20 or 30 consumers per mile of line.

Also, remember that even in the case of—I know of the systems nearby you, the largest rural electric system in the country, it is still probably—well, it is tiny compared to any investor-owned facilities.

I might add that density at Fort Myers has been achieved just in recent years when plant costs is probably four or five times as high as they were back in the 1930's and 1940's. So they still have some financial difficulties and I would venture a need for access to relatively low-cost capital. And I think a lot of times that the density factor can be somewhat misleading because I am originally from Indiana and I can remember the rural electric system that served around Indianapolis had relatively high density levels. But they may have been calculated on the basis of two or three subdivisions and yet the service area that they included included a lot of rural area where the density was still extremely low.

So, you know, maybe the average of 12 consumers per mile was skewed by say one or two subdivisions at the very edge of their service area nearest the city of Indianapolis, when the largest portion of their service area was still a very thinly populated area.

Mr. **Hubbard**. Madam Chairman, may I inject something into that?

Senator **Hawkins**. Surely.

Mr. **Hubbard**. This—I cannot cite statistics for you but I think you will find in the case of at least a significant number of our cooperatives that our experience in rapid increase and density, you will also find that as Mr. Carpenter has alluded to, the capital costs, the investment in those systems is far higher than perhaps some of the more stable systems that are in areas that are not growing as rapidly and in our own State we have at least one cooperative that is experiencing some of that. Yet the situation that is driving that growth happens to be part-time consumers to some degree that they are obligated to serve. Yet they do not have the revenue base 12 months out of the year to support the debt.

So on the surface it looks like a real good deal but when you wrap it all up in 12 months' revenue and 12 months' expense, you have a cooperative that still has to have a level of rates that is not competitive with some of the companies. It is a very complex kind of situation and it does not lend itself, unfortunately, to real—a real simple yardstick to separate the sheep from the goats, so to speak, in terms of who is entitled and who is not.

Senator HAWKINS. If they do not have year-round rates, is that not a second home?

Mr. HUBBARD. It may or may not be. But in the same instance, you have got an obligation placed on both the rural and the urban sector of that cooperative that someone has to pay. And it is difficult to—the comment was made earlier about we are no longer serving all farmers. Well, we never did. We served rural people who come to rural America to live and to work, to raise a family, to vacation, whatever. But the cooperative is ill-equipped to differentiate between this customer and this customer, this member and this member and set up one set of criteria for one that does not apply to all.

Senator HAWKINS. Is there not a trend to have amendment charges which would make the part-time consumer pay his share of the capital costs, and so forth?

Mr. HUBBARD. The policies of the various systems of course are determined by the local boards. In some instances I think that has been a trend. I could not cite specific statistics for you.

Unfortunately, minimum charges I suppose on all utilities have been going up. And that is true in that area, too.

Senator HAWKINS. Florida, like North Carolina has a great deal of second homes, vacation homes.

Mr. HUBBARD. Yes, Madam Chairman.

Senator HAWKINS. When I was the public service commissioner in Florida, we determined that we would have a different charge according to whether it is your principal place of residence.

Mr. CARPENTER. Madam Chairperson, I will say that in the State of Nebraska—unfortunately, it is not regarded as a vacation land—however, we do have people still moving into the rural areas, determined people or people who have decided they want a rural residence. And they are, as a matter of fact, 12-month residents.

Normally we try to recover all the costs incurred; still it is one more person on say a line may create more reason for service and yet does not completely substantially increase the number of consumers per mile, whatever.

At the same time, we have other kinds of loads, such as irrigation loads which are seasonal loads. And even though, again, I think we recover the cost involved, it is still—we are still in a situation where we are in a thinly populated area with higher cost per meter and lower revenues per meter. We have not seen that change appreciably probably in the 50 years because our—you take the national average, our rural electric system still has very few consumers per mile line, relatively high costs per mile of line. And that has not changed appreciably in 50 years.

Senator HAWKINS. Is Nebraska growing in population?

Mr. CARPENTER. Yes. About one point—in fact, the 1982 figures just came out and I think we grew like 1.6 percent since the 1980 census. Only 2 percent the previous 10 years.

So it is slower than the national average but it is growing somewhat.

Senator HAWKINS. Do you have any other comments you would like to make?

Mr. MURPHY. I would like to make one comment.

I heard this morning that need for the program probably is not as great now because 99 percent of rural America is electrified. About 3 weeks ago over half of Kansas was not electrified in the rural areas because of a tremendous ice storm that wiped out about 18 of our systems. So we had 85,000 consumers without electricity, many for over a week. And the Revolving Fund of course is the source of funds that we use in building. We, like Nebraska, are not a vacation land so we do not have many second homes in Kansas. We are sparsely populated. We are about half the national average because we run about 2.4 consumers per mile.

So we do have a high investment per consumer and low revenues.

Senator HAWKINS. But the natural disasters are not isolated to Kansas.

Mr. MURPHY. No; but we seem like we get more than our share.

Senator HAWKINS. I would like to invite you to Florida. Lightning capital of the world. And we have had three freezes over the last 4 years. So it is a great vacationland, but you should chose your day to come.

Mr. CARPENTER. I would like to make one last comment.

Senator HAWKINS. Surely.

Mr. CARPENTER. I would say the people in Nebraska were very conservative and are very supportive of S. 1300. I would like to impress that upon you and I would also like to say that we know that there is probably a cost involved to the rural electrification program. We think that the net benefits more than outweigh those costs in terms of the whole Nation in that it does increase the productivity for the agricultural sector which is so important.

So we think that the benefit that is realized by the Nation as a whole far outweighs what these costs may eventually bottom out to be.

Senator HAWKINS. Do any of you agree with Congressman Stenholm's amendment that explicitly mandates that interest rate formula be set so that the interest income will equal interest expense?

Mr. HUBBARD. Surely. We have no problem, Madam Chairman, with that at all. In fact, the Rural Electric Loan Program, I think, after all the rhetoric is laid to rest, if we look at it very carefully in light of where our entire Nation needs to go and all the demands that are made on the Federal Treasury and take a look at the entire utility industry, both urban and rural, I honestly believe, Madam Chairman, that the rural electric program will stand the very careful scrutiny of the light of day. There are subsidies all across the board in the utility industry and we have heard differing figures, depending on what our point of departure is for this committee today. But even with that, if we are concerned about a strong, healthy rural economy for the farm family, the suburbanite, wherever the cooperative happens to serve, S. 1300 will meet that without any unreasonable demands on the Federal Treasury, in my humble opinion.

We thank you very much for the opportunity to present the testimony.

Senator HAWKINS. Thank you.

I apologize again for having to rush you. We have a few minutes before we will be replaced here and we would like to call Robert Emiston. He is a principal of Lehman Bros. Kuhn Loeb Inc., Investment Bankers, NY; and Lee Hogan, who is the director and legislative committee chairman for the Power and Communication Contractors Association of Washington, DC.

Do you have a statement that you could summarize and then we will have questions.

STATEMENT OF ROBERT R. EDMISTON, PRINCIPAL, LEHMAN BROS. KUHN LOEB INC., INVESTMENT BANKERS, NEW YORK, NY

Mr. EDMISTON. I have a statement, and I would like to ask that it be made a part of the record.[1]

Senator HAWKINS. Surely.

Mr. EDMISTON. I understand that you are operating on a somewhat limited time schedule. I believe we have only about 10 minutes.

Senator HAWKINS. That is right.

Mr. EDMISTON. I planned to summarize my statement, and it would probably take 10 minutes to summarize it. But I think I will touch upon just a couple of highlights in that statement, that I think are important, and then respond to your questions.

The text of my remarks relates to the private market financing for rural electric cooperatives, and its development, and also the market acceptance of the securities of National Rural Utilities Cooperative Finance Corporation, or as it is known, CFC. Then I go on to discuss the importance of REA financing to assure adequate power for rural electric cooperatives, and conclude with a section that relates to the enhancement of capital availability from the private market for rural electric cooperatives.

You will notice in my prepared statement that I have referred extensively to the operations of National Rural Utilities Cooperative Finance Corporation and its growth over the past 14 years, because it is an excellent example of how to implement congressional policy of encouraging rural electric and telephone systems to develop their resources and ability to achieve the financial strength needed to enable them to satisfy their credit needs from their own financial organizations, and other sources at reasonable rates and terms.

In the section of my testimony relating to the enhancing of capital availability, I dwell on one of the important amendments that is contained in S. 1300, and that relates to the proposed amendment to section 306 of the Rural Electrification Act, particularly with respect to the accommodation of liens of non-REA lenders. It will further facilitate the development of non-REA credit for rural electric cooperatives. The point that I wish to make is that this requires particular emphasis because the REA in its accommodation of its lien to other lenders has been taking a rather narrow interpretation of granting and accommodating liens. I wish to express to this committee that accommodation of liens is essential for the expansion of private market financing for rural electric cooperatives. I think that this is well addressed in my statement, and I do not feel that I need to cover it any further.

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[1] See p. 300 for the prepared statement of Mr. Edmiston.

Senator HAWKINS. Thank you. Lehman Bros. is a principal investment banker for the CFC, is it not?

Mr. EDMISTON. That is correct.

Senator HAWKINS. Can you explain that relationship, that this involves between Lehman Bros. and CFC?

Mr. EDMISTON. Yes. We serve as principal investment banker to the National Rural Utilities Cooperative Finance Corporation. We act as financial advisors to them, and we market their securities, so we are very familiar with the way the markets accept the securities of rural electric cooperatives. A very important strength of CFC is that it is a collective financing vehicle, and by financing on a unified basis, and presenting the credit markets with the credit of all the rural electric cooperatives they are able to attract capital on more favorable terms and conditions than would be the case if individual cooperatives went to the market on their own.

So, CFC has performed a very valuable service.

We market CFC's commercial paper. They have commercial paper program outstanding, of upwards of a billion dollars at times. Commercial paper is a short-term note, having maturity of no greater than 270 days. The CFC commercial paper program has been used to fund working capital loans that CFC has been making to rural electric cooperatives, and it has also been used to provide a source of front end financing for power supply projects prior to the receipt of the REA guarantee.

In addition, we market the collateral trust bonds that CFC sells into the marketplace. These are the funds that are used to augment the distribution loan program, they are referred to as supplemental loans, that are obtained for the distribution cooperatives.

In addition, we have been very helpful, I think, in marketing the guaranteed obligations of CFC. CFC provides its guarantee for tax-exempt pollution control revenue bonds, which are sold to investors.

So I think that, yes, we have a very strong understanding of the Rural Electric Cooperative Program, and the marketplace for its securities.

Senator HAWKINS. The October 1983 hearings in the House, you testified the main criteria for deciding whether a utility is financially strong enough to borrow money in the commercial market is the degree to which its utility revenue covers its debt.

What degree of debt service coverage do the investment banks generally require of investor-owned utility, do you know?

Mr. EDMISTON. The requirement of interest coverage is really one that is determined by the marketplace, and interest coverage is only one aspect of evaluating credit. It is a very important aspect of evaluating credit.

With respect to the investor-owned utilities, they generally have coverages of between two times, and maybe three times their interest, and between that range, you will find different qualitative evaluations of their credit. So I think that interest coverage is very important.

With respect to rural electric cooperatives, you are looking at financial enterprises that have characteristics that are not entirely similar from a financial point of view to those of investor-owned utilities.

I like to describe rural electric cooperatives as having some of the financial characteristics of municipally owned utilities, as well as investor-owned utilities. With respect to the characteristics that are akin to the municipally owned utilities revenues are very, very important.

We look at the ability to cover the interest of the power supply cooperative, by the capability of the distribution cooperatives to pay their power bill. If you can demonstrate that the distribution cooperatives can consistently pay their power bills, then you do not need a high level of interest coverage at the power supply cooperative.

Generally speaking, with respect to the power supply cooperatives, interest coverage of 1.05, 1.10 times, is sufficient to attract capital because of the very strong, all requirements power supply contract running between the power supply cooperative and the distribution cooperative.

In looking at the distribution cooperatives, their financial health is very important. In that area we think that interest coverage ratios of approximately 2½ times at the distribution cooperative level is very important. Equity as a percentage of assets for distribution cooperatives, is generally about 30 to 35 percent of the total assets.

So when you look at all of that together, you need to understand the different structure of rural electric cooperatives vis-a-vis the investor-owned utilities.

Senator **Hawkins**. I understand those.

We thank you for your participation here. Now we can have Lee Hogan participate in this hearing.

STATEMENT OF LEE HOGAN, DIRECTOR AND LEGISLATIVE COMMITTEE CHAIRMAN, POWER AND COMMUNICATION CONTRACTORS ASSOCIATION

Mr. **Hogan**. Thank you, Senator.

Let me just touch on four points that are in my written testimony, that I think have not been completely addressed today.[1]

As the introduction stated, I own and operate a construction company that builds electric and communication lines in the REA Program across the country.

Senator Zorinsky touched this morning on the fact that some of the testimony had been so directed to the financial implications of this bill, that proper consideration of the REA System as a whole had not been given.

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[1] See p. 315 for the prepared statement of Mr. Hogan.

I think it is important for the committee to understand that from our experience we are able to construct facilities for REA's and RTA's across this country, that cost between 5 and 9 percent less than similar facilities we build for investor-owned utilities, and municipals. And that is a direct result of a rather remarkable system of standardization that REA has perfected over the past 50 years, that gives us a truly unique mobility to go throughout the country. In fact it is a system that has been reproduced throughout the world.

Anything such as the member of the President's Council suggested today, that would result in declaring a victory now, and dismantling this system, would completely eliminate the advantages that that system has produced for 50 years, and is going to continue to produce.

Second, the integrity of that system, and the oversight that the Government and REA are able to give, is excellent security for the private lenders in the investments that both proponents and opponents of this bill feel are necessary in the upcoming years.

The standardization, and the supervision that the REA System gives to these electric and telephone co-ops, is a tremendous sense of security and collateral for the private lenders.

No. 3, I would like to refute the fact that because rural America is now 95 to 98 percent electrified, and tied into telephone communications, the need for the REA Program no longer exists.

The majority of the work that my company, and companies in our association do for REA electric co-ops and telephone co-ops nowadays, is in the form of replacing systems that have been in existence for 40 or 50 years. In the REA Program, the depreciation and deterioration of those systems is going to continue into the future.

Finally, Senator, I would like to refute the contention that subsidies to this program, which certainly do add to the Federal deficit, impact the interest rates which private companies, such as myself, might pay.

Government participation in the capital credit markets of this country exert an upward influence on interest rates, only to the extent that they finance projects that would not otherwise be built.

If you and your colleagues, for example, decide to delete an incremental MX missile from this year's budget, that is not going to be built by anyone else in this country, that will reduce the credit requirements of this Nation, and effectively reduce interest rates. But if you delete your participation in the REA Program, those facilities are going to be built by somebody else. They are going to be funded by private capital, and the total requirements on the capital markets are going to remain exactly the same, and the effect of the interest rates will be zero.

I will be glad to answer any questions you might have.

Senator HAWKINS. Mr. Edmiston, do you agree that the proposal to forgive $7.9 billion of loans that the Treasury has made to the REA would add to the deficit?

Mr. EDMISTON. To the extent that they propose to make that $7.9 billion equity, it would not be repaying, as was originally scheduled, those amounts that were supposed to have been repaid beginning in 1993. So to the extent that those amounts do not get returned to the Treasury, they would have to be met from other sources.

Senator HAWKINS. Wall Street is very concerned about the deficit, right?

Mr. EDMISTON. When you speak of Wall Street, I like to look at Wall Street in a very broad context. Wall Street, in my mind, is really the people that put their money to work throughout this country, the managers of pension funds, life insurance companies, and other fiduciaries. People who are making investments today, and are purchasing bonds, are extremely concerned about the deficit. And the concern relates to the immediate period, over the next 1, 2, and 3, and 4 years. The concern is an immediate concern.

We are dealing with a very difficult problem. This deficit is putting us in unchartered waters, but I stress to you that it is the immediacy and the magnitude of the deficit today, not that which is going to be incurred when the Revolving Fund, which is scheduled to begin its repayment schedule in 1993.

So in the context of the Revolving Fund, I think that the timing of those repayments is of critical importance.

Senator HAWKINS. Mr. Hogan, I recently found out that many co-ops serve predominantly industrial areas. For example, one co-op sells 93 percent of its service to large commercial and industrial users.

A further examination of this co-op revealed that 93 percent consumption went primarily to a large aluminum company, and a coal company.

Two other co-ops provide 92 percent of their power to large commercial and industrial users, which include oil and refining companies, and other industries.

Would your association be affected if Congress chose to provide a greater share of the Revolving Fund money to the truly rural electric co-ops, serving primarily residential areas?

Mr. HOGAN. Senator, I also know of examples of co-ops serving loads that you describe, and I noticed in the testimony given to the House last year, particular, or specific reference was made to a co-op, in fact, here in the greater Washington, DC area. I believe you invited some people earlier in the testimony to return with you to Florida.

I would like to extend that invitation, and ask you to return to Texas, and see the Rio Grande Electric Co-op, in Brackettville, TX; with something like 10,000 miles of line, and less than 4,000 customers.

My point being, that by your citing examples in one extreme, and my citing examples in the other extreme, we are really not addressing the issue that needs to be considered, and if you are going to maintain the integrity of this system that I described to you before as so very important, you do have to in fact deal with the averages, and the averages have been testified to rather eloquently today, in terms of the density differentials, in terms of revenue differentials, and all of the other relevant ratios that Wall Street, the Government, CFC and others take into consideration, so that the greatest impact on our association and the country as a whole, would be something that would be damaging to the integrity of the system in total.

Senator **Hawkins**. I thank both of you gentlemen for participating in this hearing, and I apologize again for rushing your participation through, and the record will stay open for other Senators who would like to submit statements, or maybe ask questions of all the witnesses.

We thank you.

[Whereupon, at 1:30 p.m., the subcommittee recessed, to reconvene, at 9:30 a.m., Tuesday, May 15, 1984, in room 328-A, Russell Senate Office Building.]

RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND SELF-SUFFICIENCY ACT OF 1983

TUESDAY, MAY 15, 1984

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL CREDIT
AND RURAL ELECTRIFICATION,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:42 a.m., in room SR-328A, Russell Senate Office Building, Hon. Paula Hawkins (chairman of the subcommittee) presiding.

Present: Senators Hawkins and Zorinsky.

STATEMENT OF HON. PAULA HAWKINS, A U.S. SENATOR FROM FLORIDA

Senator HAWKINS. Good morning. The Subcommittee on Agricultural Credit and Rural Electrification is holding its third hearing on S. 1300, which purports to resolve the financial difficulties of the Rural Electrification and Telephone Revolving Fund.

As everyone knows by now, the Trust Fund is eroding and Congress must take responsible action to restore the Fund to an actuarially sound position in order to insure adequate funding for rural electric and telephone cooperatives.

This morning we will continue to expand the record on which the Senate must base its decision on how to best protect the solvency of the Fund. As I have said many times, a sound system of providing rural electric and telephone service must be maintained.

As we have discovered in our previous hearings, there is a wide divergence of opinion concerning this bill. In fact, there is little agreement as to just how S. 1300 will affect rural America.

Since we began these hearings, an alternative measure has been introduced and others are being considered. The supporters of these measures also contend that their proposals will resolve the problems of the Fund. Today we will hear more testimony from interested parties on the problems and the fate of the Trust Fund and the REA Program itself.

We want to thank the rural electric and telephone customers and the urban taxpayers for watching these hearings so closely, and we would like to tell those customers also that we are looking closely at this program. We have received a lot of mail on this subject, as you may imagine, and we are sure that each party involved in the debate will agree that our goal is to make the system work in the most efficient and fair manner possible.

Today we will first hear from Tony Gabriel, Deputy Inspector General, U.S. Department of Agriculture, Washington, DC.

Welcome. You have a short statement. Would you like to condense it for us?

STATEMENT OF ANTHONY J. GABRIEL, DEPUTY INSPECTOR GENERAL, U.S. DEPARTMENT OF AGRICULTURE, ACCOMPANIED BY DONN ADKISSON, ASSISTANT INSPECTOR GENERAL FOR AUDIT

Mr. **Gabriel.** Good morning, Madam Chairman. I am delighted to be here today to provide your subcommittee with some of the information that we have, and appreciate being able to provide it as part of the entire oversight that your subcommittee is making on this subject.

I have with me this morning Mr. Donn Adkisson. He is the Assistant Inspector General for Audit.

I will proceed the way you suggested.

Senator **Hawkins.** Please.

Mr. **Gabriel.** I will just summarize some of my comments.[1]

Madam Chairman and members of the committee, I appreciate the opportunity to appear before you today to discuss audits the Office of Inspector General has made of the Rural Electrification Administration.

OIG's two audits of electric distribution cooperatives centered on the financial condition of the Revolving Fund, REA's loan-making policies, and REA's controls over borrowers' receipts and use of loan funds.

We found that Revolving Fund assets are diminishing and will need to be supplemented unless interest rates charged to the borrowers are increased and loan-making criteria are changed.

We also found REA made loans to electric cooperatives which had sufficient financial strength to obtain funding without subsidized interest rates, and to borrowers which serviced areas that were no longer basically rural in characteristic.

Some cooperatives used loan funds for purposes not authorized by REA and controls were not in place to preclude the premature drawdowns of subsidized loan funds which we found were deposited in high-interest-bearing accounts.

With respect to the financial condition of the Revolving Fund, our observations: From the Fund's inception in 1973, loan disbursements exceeded incoming revenue. In 1976, REA began selling certificates of beneficial ownership, CBO's, to obtain additional funds to loan, and thus began incurring interest expense.

As of October 20, 1983, assets of $3.4 billion have been sold, bearing interest rates up to 15.325 percent. REA also borrowed funds from Treasury for short terms with interest rates as high as 16.375 percent to partly pay interest expense on the CBO sales.

At the time of our audit, REA determined through computer modeling that the Revolving Fund interest expense will exceed interest income by the second half of fiscal year 1985. Appropriations will be needed to cover the shortfall or additional assets would need to be sold.

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[1] See p. 321 for the prepared statement of Mr. Gabriel.

If the trend continues, which is expected because of the rates charged borrowers of 2 and 5 percent, all of the Fund's assets will be sold by the year 2004. Because of these shortfalls, we recommended that REA seek legislative authority to increase borrower interest rates up to the cost of Government borrowing. We also recommended that the increase in loan interest rates be based on the borrower's financial condition as opposed to the present flat rate.

As you are aware, on April 11, 1984, the Secretary of Agriculture asked Congress to consider a draft bill to amend the Rural Electrification Act of 1936 to insure the continued financial integrity of the Rural Electrification and Telephone Revolving Fund, and for other objectives.

Our one audit report also explored other financing alternatives. We recommended as an alternative that REA institute a loan guarantee program through commercial sources to provide a loan source to financially strong cooperatives that can afford higher interest rates.

With respect to the cooperatives serving nonrural areas, our observations: The Rural Electrification Act defines rural areas as those not included within the boundaries of any city, village or borough having a population in excess of 1,500 inhabitants.

We found that 54 cooperatives currently serve areas where 50 percent or more of the consumers reside in a standard metropolitan statistical area with at least 50,000 inhabitants. These 54 cooperatives received REA-subsidized loan funds totaling about $600 million from 1979 through 1982.

The Department's proposed bill submitted by the Secretary of Agriculture on April 11 would give the Administrator more latitude to target funds to rural areas.

On the financial strength of cooperatives, we determined that 110 cooperatives had sufficient financial strength. The financial positions of the cooperatives were compared to investor-owned utilities whose service areas were adjacent to those of the cooperatives. Our conclusion was that the 110 cooperatives had more favorable financial positions and appeared capable of obtaining unsubsidized credit.

The Department's draft bill would provide greater discretion to the Administrator to determine ratios and criteria for supplemental financing.

With respect to the drawdown of loan funds, REA requires that a cooperative's general funds must fall below a specific level before a loan advance can be made. We statistically projected that REA advanced approximately $254 million to cooperatives which was either premature or not needed. We estimated that for each month the cooperatives gained premature access to loan funds, the Government incurred interest costs of approximately $1.2 million. I will only mention briefly, Madam Chairman, that we are currently conducting an audit of the Telephone Loan Program and the Rural Telephone Bank, and our preliminary findings indicate that the issues identified to date closely parallel those disclosed during our audits of the distribution cooperatives. They are somewhat related, but we have not completed the audit and finalized our audit report.

So with that, Madam Chairman, I conclude my statement and we can proceed whatever way you so desire.

Senator **Hawkins**. Thank you, Mr. Gabriel, and we welcome Senator Zorinsky.

You stated in your analysis of S. 1300 that the Fund's problems stem from the inflexibility of mandatory, fixed interest rates, is that correct?

Mr. **Gabriel**. Yes.

Senator **Hawkins**. Would you expand upon that comment?

Mr. **Gabriel**. We confirmed the GAO and the CBO studies, and I believe your question was with respect to the GAO and the CBO. Did I interpret that correctly?

Senator **Hawkins**. That is one of them. I will ask a similar question. You stated in your statement that the Revolving Fund is becoming fiscally insolvent, and I believe you stated several times that the Fund's exenses will exceed its income.

Mr. **Gabriel**. Yes.

Senator **Hawkins**. Would you explain why this is the case?

Mr. **Gabriel**. We confirmed, as some of the other reports have shown—the GAO and the CBO studies—that the Fund is in financial difficulty and that the Fund will require direct appropriations before the year 2000 to continue to operate.

The primary reason for this condition is the interest rate subsidy that the Fund is incurring. The loans are limited, as you know, to an interest rate of 5 percent, while the interest cost to the Government in the last several years has been as high as 15 percent.

In our report issued in May 1983, on page 15, we chart the interest rate on REA loans versus the cost of money to the Government from 1936 through 1981. The table shows the difference in interest rates that had developed, particularly after the Revolving Fund was established in 1973.

[The following information was received by the subcommittee:]

INTEREST RATE ON REA LOANS VERSUS COST OF MONEY TO THE GOVERNMENT

Fiscal year	Interest rate paid by borrowers on REA loans	Computed annual interest rate on marketable Treasury issues
1936	3.00	2.530
1937	2.77	2.525
1938	2.88	2.521
1939	2.73	2.525
1940	2.69	2.492
1941	2.46	2.413
1942	2.48	2.225
1943	2.57	1.822
1944	2.67	1.725
1945	2.00	1.718
1946	2.00	1.773
1947	2.00	1.871
1948	2.00	1.942
1949	2.00	2.001
1950	2.00	1.958
1951	2.00	1.981
1952	2.00	2.051
1953	2.00	2.207

INTEREST RATE ON REA LOANS VERSUS COST OF MONEY TO THE GOVERNMENT—Continued

Fiscal year	Interest rate paid by borrowers on REA loans	Computed annual interest rate on marketable Treasury issues
1954	2.00	2.043
1955	2.00	2.079
1956	2.00	2.427
1957	2.00	2.707
1958	2.00	2.546
1959	2.00	2.891
1960	2.00	3.449
1961	2.00	3.063
1962	2.00	3.285
1963	2.00	3.425
1964	2.00	3.659
1965	2.00	3.800
1966	2.00	4.134
1967	2.00	4.165
1968	2.00	4.757
1969	2.00	5.232
1970	2.00	5.986
1971	2.00	5.210
1972	2.00	5.099
1973	3.72	6.129
1974	4.52	7.030
1975	4.42	6.533
1976	4.02	6.559
1977	3.88	6.481
1978	4.35	7.388
1979	4.27	8.592
1980	4.37	9.608
1981	4.38	12.435

Senator Hawkins. You say also that you feel that the Fund's problems stem from the inflexibility of mandatory, fixed interest rates. Would you expand on that, also?

Mr. Gabriel. When the cost of REA borrowing from the Federal Financing Bank increases, REA is unable to adjust its interest rates on loans to electric and telephone borrowers in order to offset its increased costs.

The Revolving Fund must absorb those costs, and therefore REA has no control over deterioration of the Revolving Fund. Additionally, REA has no control over the rate of subsidy on loans to its borrowers. The rate of subsidy on REA loans is the difference between REA's cost of borrowing and the mandatory lending rate of 5 percent.

For example, when REA's cost of borrowing increases from 11 to 12 percent, the subsidy rate increases from 6 to 7 percent. While I was preparing for these hearings, I saw summary comments by the Assistant Secretary of Treasury and he used an example that I thought was directed to this point on the subsidy.

He said at the current cost of long-term Treasury borrowing of about 12.5 percent, the cost of making a typical 35-year loan at 5 percent for $3 million is the same as the cost of providing an outright grant of $1.6 million, with the remaining $1.4 million being paid at the 12.5-percent rate. That, I thought, illustrated the effect of the difference in the cost of Government borrowing and the interest income that is received when loans are made at low fixed interest rates to REA cooperatives.

Senator HAWKINS. Would you please explain why you feel that S. 1300 would not put the Revolving Fund on a self-sustaining basis?

Mr. GABRIEL. Donn, do you want to take that?

Senator HAWKINS. Thank you. Mr. Adkisson?

Mr. ADKISSON. The interest rate formula contained in S. 1300 is not designed to make the Fund self-sustaining. The formula factors in the annual appropriations are to cover the cost of interest subsidies on special rate loans made to hardship case electric and telephone borrowers.

S. 1300 also expands the eligibility for special hardship loans; that is, loans with interest rates below the 5 percent or standard interest rate. Additionally, the interest rate formula includes repayments of loan principal on existing loans and advances on new loans in a determination of the interest rates charged by REA, but excludes CBO principal repayments owed by REA.

Thus, this would prevent REA from using the loan principal repayments to the Fund to retire debts already owed by the Revolving Fund. REA would then be forced to refinance rather than repay the debts owed by the Fund—the CBO's and the Treasury notes.

Senator HAWKINS. What is the basis of the Inspector General's recommendation that interest rates from the Fund should reflect the cost of Government borrowing?

Mr. ADKISSON. That would be in order to make the Fund self-sustaining. The current interest rates charged by REA, the mandatory 5- and 2-percent interest rates, are not sufficient to cover the cost of Treasury's borrowings which reached 16 percent at one time for REA short-term borrowings. Given the difference in interest rates the Fund cannot be self-sustaining.

Senator HAWKINS. Mr. Gabriel, I am concerned about the impact that legislation would have upon user rates, and therefore want to make sure that I understand your statement.

On page 6 you say that you examined 110 cooperatives, and 110 of 117 cases you reviewed in detail, and that user rates charged by financially strong co-ops would remain competitive with rates charged by IOU's.

Can you elaborate further and tell us what impact this has upon the Revolving Fund?

Mr. GABRIEL. As you pointed out, we found that 110 of the 117 cooperatives have stronger financial ratios than neighboring investor-owned utilities, IOU's. We found they had a minimum of 50 percent equity and a times interest earned ratio of at least 2.5.

I might say our reports have an introduction that provides a basis for interpreting ratio analyses; that is, in looking at financial statements and the assets and liabilities and net worth, we explain a criterion in how these are used to make evaluations—the significance of using TIER and also the equity ratio.

We analyzed the effect that increased interest cost would have on the typical monthly residential electric bills at a 1,000-kilowatt-hour usage level for the 117 cooperatives. This analysis showed that the increased cost of interest at the higher U.S. Treasury interest rate did not have a significant impact on retail electric rates. The rate increase was generally less than 5 percent.

Senator **Hawkins**. What is the basis of your recommendation that legislative changes be made in the loan-making ratios and criteria?

Mr. **Adkisson**. The current loan-making ratio is that the cooperatives must get at most 30 percent of their financing from commercial sources and the remaining financing from REA at the fixed interest rate, which would be 5 percent in a case where REA requires concurrent commercial financing.

We ask for a combination of increases between raising that ratio of 30 percent to a higher rate and raising the interest rates up to the cost of borrowing by the Treasury, and that is the basis that we made our recommendation on.

Senator **Hawkins**. Do you know the number of cooperatives which may not be serving rural areas but are serving primarily resort areas?

Mr. **Gabriel**. Madam Chairman, we do not have an answer to that question. While our reports do show in the appendixes all of the cooperatives that we have examined and provide the backup for the information in our reports, we would have to try to obtain an answer to that question with further analysis.

Senator **Hawkins**. Would you provide it for the record, please?

Mr. **Gabriel**. Yes.

[The following information was subsequently received by the subcommittee:]

REA does not maintain statistics that would identify resort facilities or communities served by electric cooperatives. Our audits were not designed to identify cooperatives serving primarily resort areas. Our audits did identify 54 cooperatives serving primarily (at least 50 percent) non-rural consumers. Furthermore, we identified 80 cooperatives with 20 percent or more of their consumers in a Standard Metropolitan Statistical Area (SMSA). Our analysis was based upon cooperatives with 15,000 or more consumers providing service in a SMSA which by definition of the Department of Commerce contains at least 50,000 inhabitants. Our analysis therefore did not evaluate the service areas of 742 cooperatives with less than 15,000 consumers, nor of 109 cooperatives with at least 15,000 consumers but not serving a SMSA. It is probable that some of these 851 cooperatives serve small and median sized suburban areas. In response to your question, we have compiled the following list of cooperatives which serve resort areas, but we are unable to determine from REA statistics the quantity of electric power consumed by the resort areas. Detailed analysis of power usage would require reviews of cooperative power sales records. This list was developed based upon generally recognized resort areas and should not be construed as including all possible instances of cooperatives serving resort areas.

COOPERATIVE AND RESORT AREA

1. Joe-Carroll ECI Elizabeth, IL; Galena Territory.
2. Arrowhead ECI Lutsen, MN; Lutsen Ski Resort.
3. New Hampshire ECI Plymouth, NH; Ski Areas, Waterville Valley, Cannon Mountain, Loon Mountain and Mount Cranmore.
4. Brunswick EMC Shallotte, NC; Ocean Isle Beach, Holden Beach and Long Beach.
5. Carteret-Craven EMC Morehead City, NC; Atlantic Beach and Emerald Isle.
6. Valley Rural ECI Huntingdon, PA; Blue Knob Ski Resort Area.
7. Vermont ECI Johnson, VT; Smugglers Notch Ski Resort Area.
8. Baldwin ECM Summerdale, AL; Gulf Shores Area.
9. Palmetto ECI Hilton Head, SC; Hilton Head Island Resort.
10. Berkeley ECI Moncks Corner, SC; Kiawah Island Resort.
11. Laclede Electric Coop Lebanon, MO; Lake of the Ozarks—Southside.

12. Co-Mo ECI Tipton, MO; Lake of the Ozarks—Northside.
13. Kit Carson ECI Taos, NM; Taos Ski Resort Area.
14. Southeastern ECI Durant, OK; Lake Texoma.
15. Fannin County ECI Bonham, TX; Lake Texoma.
16. Pedernales ECI Johnson City, TX; Lake Travis Resort Area.
17. Sam Houston ECI Livingston, TX; Lake Livingston Resort Area.
18. Rio Grande ECI Brackettville, TX; Amstad Lake Resort Area.
19. San Luis Valley Rural ECI Monte Vista, CO; Wolf Creek Ski Area.
20. Gunnison County EAI Gunnison, CO; Crested Butte Ski Area.
21. San Miguel Power Assn. Nuda, CO; Telluride Ski Area.
22. La Plata EAI Durango, CO; Durango Ski Area.
23. Holy Cross EAI Glenwood Springs, CO; Vail, Aspen and Snow Mass Ski Resort Area.
24. Yampa Valley EAI Steamboat Springs, CO; Steamboat Ski Area.
25. Mountain Parks Electric, Inc. Granby, CO; Winter Park and Blue Ridge Ski Areas.
26. Fall River REC Ashton, ID; Yellowstone Ski Area.
27. Prairie Power Coop., Inc. Fairfield, ID; Soldier Mountain Ski Area.
28. Lower Valley Power & Light Inc. Afton, WY; Jackson Hole Resort Area.

Senator HAWKINS. Do you have any additional information concerning large industrial and commercial co-ops?

Mr. GABRIEL. Mr. Adkisson has some information on that.

Mr. ADKISSON. According to the latest REA statistics, they break down the users by the use of kilowatt hours, and the latest statistics we have available at this time are from 1981.

Large industrial users represent about 25 percent of the total usage of power, and small industrial users represent about 8 percent of the total usage of power.

Senator HAWKINS. You do not have the 1982 data?

Mr. ADKISSON. We do not have it with us. We will supply it for the record.

[The following material was subsequently received by the subcommittee:]

For 1982, REA statistics show that 32.5 percent of power sales (KWHs) by electric distribution borrowers went to large and small industrial users with 24.4 percent of sales going to large industrial users and 8.1 percent of sales going to small industrial users. REA has, however, informed us that the breakdown between large and small users may be slightly in error due to borrower misinterpretations of the definition separating the two groups.

Additional statistics for 1983 show that of 924 reporting electric distribution borrowers, 26 cooperatives sold 50 percent or more of total power sales to large industrial users while another 82 cooperatives sold 50 percent or more of total power sales to small and large industrial users. These statistics include 28 cooperatives that sold between 70 and 95 percent of total power sales to industrial users. The following table breaks down cooperative power sales to industry:

Number of cooperatives	Percent of total power sold to industrial consumers
5	90 to 95.
9	80 to 89.9.
14	70 to 79.9.
36	60 to 69.9.
44	50 to 59.9.
71	40 to 49.9.
128	30 to 39.9.
617	Less than 30.

Senator HAWKINS. Based on your audit analysis, what effect would the higher interest costs associated with conventional financing have on the co-ops' electric rates?

Mr. **Gabriel**. I think it is somewhat related to our comments on the earlier question. We found that about 66 percent of the cooperatives' total revenue is used for power costs. Interest costs consume only about 5 percent of the cooperatives' total revenue. Therefore, the effect of higher interest rates, up to the cost of Government borrowing, would not significantly affect retail electric rates.

This position was supported also by a financial consultant that we had working with us at the time of our audits. We had him analyze some of the cases that we were involved with.

Senator **Hawkins**. Your report discussed cooperatives that received subsidized loan funds through transactions which OIG questioned or at a time when the funds were apparently not needed to meet expenses. Could you elaborate on that?

Mr. **Gabriel**. I could start; I have some data, and then Mr. Adkisson has some more pointed examples.

Senator **Hawkins**. Please.

Mr. **Gabriel**. Based on a sample of 65 statistically sampled electric cooperatives, we projected questionable drawdowns of $250 million. The cooperatives' general funds were reduced by questionable transactions such as prepayment of power costs.

Although these transactions are allowable under REA procedures, they sometimes provided the cooperatives access to 2 and 5 percent REA funds when not really needed. For example, we projected that shortly after drawdowns of REA funds, the cooperatives invested $197 million in certificates of deposit and other instruments at rates of interest up to 20 percent.

Mr. **Adkisson**. I have one specific example of one co-op that reduced its general fund level below 8 percent 18 separate times to obtain loan advances of $18 million. To accomplish this, the co-op prepaid its power costs—in other words, paid for the power before it was actually due—prepurchased supplemental financing certificates, in other words, prepurchased investment certificates from the National Rural Utilities Cooperative Finance Corporation (CFC) which are required to be purchased as a condition for obtaining loans from CFC. (These certificates pay high interest rates for time periods in advance of required purchase dates.) And prepaid long term loan debts to REA and retired patronage capital.

So at the same time that they were asking to borrow from REA, they were prepaying existing indebtedness to REA in order to reduce their general fund level below the 8 percent, and thereby become eligible for the 5 percent interest rates.

Senator **Hawkins**. This past week, Senator Simpson raised a number of issues relating to this legislation. Have you been able to review those statements and could you say that he accurately presents the problems with this legislation?

Mr. **Gabriel**. Madam Chairman, I did get an opportunity to review that. I also had an opportunity to review summaries of some of the previous witnesses—GAO, Congressional Budget Office, and Treasury. I thought that Senator Simpson did a very good job of pulling this information together.

One of the things that I was particularly interested in was the fact that he said that he was working with this program for almost 5 years. He thought that an awareness had been created in the

Congress to begin oversight or to try to pull these problems together to get something done.

So when there are so many complexities to this type of program—and as Senator Simpson has said and as we understand, this is an off-budget program funded by the Federal Financing Bank and people who are attuned with financial management and accounting and have worked around the checks and balances of Government—we feel, as Senator Simpson has felt, that the appropriation process should be the avenue for these types of programs because when you use the appropriations process, if there are to be subsidies and if there are cooperatives out there that need help, the cost to the Government should be quantified and should be presented through the discipline of an appropriations process. Then such a program would compete with other Government programs in the appropriation process.

I cannot help but appreciate what Senator Simpson said when he talked about the financing commitments, off-budget borrowing, and the extraordinary array of the types of activities. Yes, it is very complex to obtain funds from the Federal Financing Bank with interest-free loans which creates a $7.9 billion revolving fund, then the Federal Government, as it begins to have problems in creating enough cash flow, goes back to the Treasury and borrows in the form of certificates of beneficial ownership.

So, I think Senator Simpson showed good understanding and oversight in pulling this information together and bringing this problem to where it is, I believe, today. There is recognition in the community that there is a problem and that people are trying to explore avenues to fix it. That is the way I interpreted his memorandum, or the Congressional Record.

Senator HAWKINS. Thank you, Mr. Gabriel.

Senator Zorinsky.

Senator ZORINSKY. Thank you, Madam Chairman.

You indicate the appropriations process is the place to make these types of considerations. Have you ever seen the appropriations process at work at 3:00 in the morning?

Mr. GABRIEL. No, sir, not that late.

Senator ZORINSKY. Unfortunately, I have, and I wish more people could see it. It is probably as disorganized as what you indicate the alternative to that is.

In your earlier comment and reply to Madam Chairman on one of her questions, the differential on interest if conventional loan authority were available in REA—you said the differential represents about 5 percent of the cost of the rate to the ratepayer.

Can you in percentage terms indicate if that would raise an electric rate 5 percent per annum or 2 percent per annum for an electrical user in a rural area?

Mr. GABRIEL. I cannot quantify it to those exact percentages. We do show the computation of a typical electric bill before an increase in interest, and rates of a typical electric bill with an increase in interest. We do show by cooperative in many instances what this would be. I have not worked the computations, sir, to quantify it in the terms you expressed.

Senator ZORINSKY. Do you feel that is accurate enough that it could be locked into law?

Mr. **Gabriel**. Well, the rest——

Senator **Zorinsky**. I always hear numbers on tables and then when something gets written into law, it turns out it is either ten times as much or five times as much. Then people say, well, how was I expected to know that this was going to happen this year?

The point I am making is, is this authoritative enough to be actually frozen and written into differential and law?

Mr. **Gabriel**. I would rather recompute it, and also have a validation. The General Accounting Office, I noticed, in preparing——

Senator **Zorinsky**. You would recompute it?

Mr. **Gabriel**. I would recompute it.

Senator **Zorinsky**. Who computed it to begin with?

Mr. **Gabriel**. Well, this comes through the audit process, all the way from our field activities into the headquarters activity.

Senator **Zorinsky**. But you do not feel this is valid?

Mr. **Gabriel**. I feel it is a good estimate, but before you would lock it into law, I would feel that we would want to use the term "validate" it. If you were going to fix a rate in law, we would want to make sure and be positive that it was confirmed.

Mr. **Adkisson**. If I might add, the schedules that we did in the audit report pertained to specific cooperatives, and what reflection the increased interest rates would have for a particular cooperative.

Certainly, with something as expansive as law itself, we would not want to have a law that is so inflexible that it would not allow for giving greater advantage to those cooperatives and their members that need the subsidized loan rate.

Senator **Zorinsky**. Well, the point I am trying to make is that without S. 1300, our fear is that electrical energy rates could be confiscatory to the point of unaffordability in the rural areas because of the differential.

Your claim is that it will be minimal and less objectionable than what we feel it would be.

Mr. **Adkisson**. Yes, sir. I think the one thing that we could center on is the majority of the costs of the operation of a cooperative is the cost for power, not interest repayment on long-term debt. We find that the cost of power consumes about 66 percent of the total revenue of a distribution co-op.

So if that continues to be an average, then your long-term debt, if you raise it to the cost of borrowing, should not have a major impact on the cost to the consumer of the power.

Senator **Zorinsky**. Well, it is the very cost and differential of energy attainability that sometimes can make the small differential in interest the straw that breaks the camel's back in being able to afford the availability of that energy, especially when we are talking about long-term bond issues.

Mr. **Adkisson**. That, of course, is a possibility. We have found that 110 distribution cooperatives are in large part financially sound; in fact, more sound than their counterparts, the investor-owned distribution utilities.

Senator **Zorinsky**. Both of you gentlemen have made several criticisms of the REA Program, and my question to you is can you tell the members of this committee to what extent those criticisms are based on violations of law or regulations?

Mr. **Gabriel**. Yes. We talked about some problems with work orders and problems with procedure. Original work plans would be approved and then there would be changes, modifications, and deferrals.

The work plan as a management tool is a discipline and a priority setting of what construction or what projects are to be completed. So while, there was unapproved or unauthorized work, it was not illegal.

I say that because some of the cases were checked out with U.S. attorneys and there was enough flexibility in the rules and procedures that allowed these things to be done. So there was a need to tighten up the process and tighten up the procedures.

Senator **Zorinsky**. But none of them actually fell in the purview of illegal activity?

Mr. **Gabriel**. No, sir.

Senator **Zorinsky**. Thank you, Madam Chairman.

Senator **Hawkins**. Senator Huddleston had a question; I believe it was the same question you asked.

Thank you. We will excuse these witness at this time—we appreciate your participating in this hearing.

Mr. **Gabriel**. Thank you. It was nice of you to have us.

Senator **Hawkins**. The second panel is Dr. William Orzechowski, director of Federal Budget Policy, Chamber of Commerce of the United States, Washington, DC; and Baker Smith, executive vice president of the United States Business and Industrial Council, Washington, DC.

Dr. Orzechowski, we have your statement. Would you proceed?

STATEMENT OF DR. WILLIAM ORZECHOWSKI, DIRECTOR, FEDERAL BUDGET POLICY, CHAMBER OF COMMERCE OF THE UNITED STATES

Dr. **Orzechowski**. Madam Chairman, we are happy to be here today to testify on the Rural Electrification and Telephone Self-Sufficiency Act. Madam Chairman, I want to give a summary of my statement at this point.[1]

Senator **Hawkins**. Thank you.

Dr. **Orzechowski**. The Chamber looks at this program from a budgetary point of view. We feel that one of the greatest problems facing this country over the next 20, 30 years or so is the growth of Federal Government expenditures. We all know that we have a major deficit problem right now.

One of the more vexing problems of this growth of Government expenditures is off-budget activity. Real government expenditures are growing at an annual rate of 3.5 percent. If we project that out to the year 2000, we get Federal expenditure as a percentage of GNP being something close to 40 percent of GNP by the year 2000.

If we take the 24 percent of Federal Government expenditures that exist now and add on to it the State and local level of expenditures, we have got about 40 percent of the GNP being involved with Government activities one way or the other.

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[1] See p. 330 for the prepared statement of Dr. Orzechowski.

So we think it is an important thing to try to stop some of these programs in their tracks, or at least try to bring them into question.

Now, the FFB plays a big part in off-budget activities. Approximately 96 percent of all off-budget loans go through the FFB. The REA gets something like 41 percent of the loan guarantees through the FFB, and is the second largest borrower through CBO's, certificates of beneficial ownership.

We feel that the REA provides an important test case in terms of fiscal responsibility. You know, we have a system where we have many small projects plugged into that Federal budget and specific special interest groups gain from those projects, and a lot of times those projects have merit, but in a lot of cases they run awry. They run against the basic nature of the original intent of that program.

While we are not questioning the existence of the REA Program per se, we feel that the Program has gone awry. The bulk of our contention is based on the spread of interest rates.

When the REA started out, for the first 16 years of the REA from 1936 to about 1958, the REA did indeed pay its own way; that is, if you looked at the Government borrowing rate, which was about 2 percent or so, and then you looked at the rate that the REA borrowers were paying, that was about 2 percent, also. This existed up until about 1955, 1956.

That was also probably the most important phase of REA. When the Program started in 1936, a good portion of rural America was not electrified and it was a very successful program relative to other kinds of Government programs. However, by the middle 1950's, over 90 percent of all farms were electrified.

Yet, precisely in that most important phase, the early phase, we found that the interest rate that was being charged to borrowers was very close to the market rate. Paradoxically, as we go on in time, from the late fifties, through the sixties, through the seventies, up to the present time, we find that as the REA surpassed its most important phase, the interest rate spread becomes greater and greater.

Now, in part this is probably due to the fact that there is some sort of inertia in terms of readjusting interest rates upward over time. That, coupled with the fact that the market rates rose because of all the inflationary pressures that started to bubble up in the 1960's and continued through the 1970's—interest rates basically follow in large part inflation over a long-run period of time.

What happened was that the interest rates on the REA loans were never pegged in tandem with rising market rates. We feel this is the basic contention. We feel that REA should pay its own way; that is, it should pay interest rates somewhat close to market rates or the Government borrowing rate, the way it did in the early part of its existence.

Otherwise, we believe you create a dilemma of priorities. Maybe it is possible that voters want this kind of priority; I do not know. But at least they ought to have a chance to vote on it or a Congressman should have a chance to directly oversee this procedure so that maybe we can make these priorities more clear.

We find it somewhat of an anomaly that young homeowners—people in their thirties and forties—cannot even buy their first house because interest rates are up around 14 or 15 percent. Mortgage interest rates are at that level, while at the same time co-ops are getting interest rates on loans at 5 percent. We think that is a perverse or weird set of priorities.

That is not really our question to resolve, but that is a question that should be resolved somewhere along the line. If these programs were brought on budget or if they were scrutinized more clearly, maybe we could get into some of these dilemmas.

Now, for that reason, we support the Bethune amendment. We have looked at the Bethune plan and it seems to us that for a difference of 3 percent, in other words, the Bethune plan I think has about an 8.75-percent long-run interest rate, or 9-percent long-run interest rate, whereas S. 1300 and H.R. 3050 have a long-run interest rate of somewhere around 6 percent—3 percent difference, you solve a number of problems. The first problem you solve is that you will not run into insolvency with the Bethune plan. It does not require forgiveness of the $7.9 billion to the Treasury, plus interest. It does not require the rollover of the CBO's. It does not require refinancing downward of the CBO's. We think that is the way to go. We applaud Congress in the sense that it is trying to resolve the problem. We think that they should go another step forward and endorse the Bethune amendment.

From our estimates, by going 3 percent higher, the cost of electricity to the typical consumer will only go up by something like 45 cents; CRS estimates it is 15 cents for each 1 percent increase in the interest rate that customers pay. Their bills go up by something like 15 cents per month, so we think that this is the sensible way to go in terms of fiscal responsibility.

Even with the Bethune plan, with a longrun interest rate of something like 9 percent, if you compare that to the Government borrowing rate of 12 percent or a market rate of, let us say, 13 or 14 percent, there still remains a hefty subsidy. It is a bigger subsidy than the subsidy that existed when REA was in its most important phase, those first 14 years when the rates were approximately equal. The Chamber therefore supports the Bethune amendment.

To cap it off, James Madison once said that one of the biggest problems that a nation would face in terms of budgeting and in terms of appropriations was the violence of the faction—the case where a small, well organized interest group basically gets benefits that do not come up to costs and push through programs which to a large extent are hidden from the general taxpayer.

Now, I am not saying that REA in all of its facets is an example of the violence of the faction, but we have many cases like that within the Federal expenditure component. If we cannot come to grips with this problem and if we cannot just simply get the interest rate somewhat equal to what it was in its early phase, then, I do not think we have much of a chance in stopping the spiral upward of Federal expenditures in the long run.

If we do not do that, I am afraid we will just be resigned to a slow crumble just like the Roman Empire—a slow economic growth rate. So I think this is an important test case and the Chamber supports the Bethune amendment.

Senator HAWKINS. Thank you, sir.

Mr. Smith, do you have a summary of your statement?

STATEMENT OF BAKER A. SMITH, EXECUTIVE VICE PRESIDENT, U.S. BUSINESS AND INDUSTRIAL COUNCIL

Mr. SMITH. Yes, I do, Madam Chairman.[1] I appreciate the opportunity to be here today and speak on behalf of the U.S. Business and Industrial Council. That group was founded in 1933 and is composed of several thousand senior corporate executives nationwide, including a number of customers who are served by REA.

Our members oppose S. 1300. We feel it is a bailout, and we would like to see the market operating and not the taxpayers footing the bill for REA.

When I graduated from law school just a few years ago, I was offered a job at REA, along with one of my classmates. She and I both turned the jobs down because we became convinced that the REA at that time, based on its own representations to us, had largely completed its function and had by that time electrified 99 percent of rural America.

It was clear that there were a number of massive expenditures of funds going on even then which we did not feel were the kind of thing we wanted to be involved in.

Now, the fact that REA has been characterized as a classic is no reason, we believe at USBIC, to take this bill less than seriously. It has been characterized as a classic because it goes back to the New Deal days. It is off-budget; in other words, it is an expenditure that can be more easily hidden from the taxpayers, and the constituents are mobilized in this case when significant expenditures of other Federal agencies are at stake.

But this bill is not a microcosm. In other words, to consider it a classic in the sense that it might be a microcosm would be inaccurate. This $8 billion is a significant amount of money. This amount of money is equivalent to a significant portion of the budgets of many of our Cabinet level agencies.

In other words, this seemingly small agency, insignificant perhaps, is engaged in massive expenditures of funds far beyond its apparent scope. The strongest indication of the dollars at stake is certainly the massive lobbying presence that we see mobilized here.

But why should not people be interested, Madam Chairman? This is great leverage. A single bill, S. 1300, can leverage $8 billion. In these days of Congressional concern for excessive spending and deficits, it is undoubtedly a real temptation to somehow characterize this expenditure as more worthwhile, for example, than so-called entitlement expenditures.

The REA constituents are obviously a high-quality, middle class people. With a few exceptions, they did not arrive here by bus caravan, and unlike the entitlement expenditures, they can claim that there are some tangible assets after the money has been spent—a few powerplants and substations to show for the money.

The problem with my analogy that I have just given you is that most Federal spending, including the so-called entitlements, ends up in the pockets of the middle class, not the poor.

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[1] See p. 335 for the prepared statement of Mr. Smith.

As to the argument that you end up with tangible assets, it is the worst buy for the money. We have heard plenty of previous testimony on that. It is not a buy that Congress can be proud of.

Why would Congress want to spend the money in the first place on such undeserving projects that are financially undeserving?

The REA constituents, and they are our constituents as well, are concerned about out-of-control Federal spending, and they have said so. There is concern about any of the other citizens. I know because most of the U.S. Business and Industrial Council members who are REA constituents have let us know that they are concerned.

Just because it is an off-budget item does not mean that we will not see its results in the deficit, because it will show up in the shortfall between revenues and expenditures; it will show up eventually even though it will not be a budget item.

In short, S. 1300 is a caricature of everything that is wrong with Federal spending, but it is also a very bad bill with a significant impact and we urge you to vote against reporting this bill to the full committee.

[The following letter was subsequently received by the subcommittee:]

U.S. Business and Industrial Council,
June 11, 1984.

Hon. Walter Huddleston,
U.S. Senate,
Washington, DC.

Dear Senator Huddleston: Pursuant to your written question subsequent to my testimony before the Agriculture Credit and Rural Electrification Subcommittee on May 15, 1984, as I stated at that time, the U.S. Business and Industrial Council is deeply concerned over runaway federal spending and off-budget financing. This forms the basis for our opposition to S. 1300.

Of course, the $7.9 billion bailout amounts to a so-called "benefit" for REA consumers, and we have no indication or membership polling either way on this.

However, I would like to make some additional points on this so-called benefit. The U.S. General Accounting Office estimates that the benefit lost in the average difference in yearly electric rates should this bailout be denied only amounts to an increase of approximately 4 cents per month for the average ratepayer. That slight increase would seem preferable to giving an average of approximately 85 cents per month for each consumer served by Rural Electric Cooperatives—the equivalent of dividing the $7.9 billion bailout by the number of consumers served.

The actual "benefit"—no matter how great—needs to be considered in terms that do not pretend that no one will have to pay the cost. This debt is significant, and even though it is "off-budget" the U.S. taxpayer must still make up the difference between revenues and expenditures.

Thank you, Senator, for your interest in our organization's views of this legislation. We believe the above points underscore the statements contained in our testimony on this subject.

Sincerely,

Baker A. Smith,
Executive Vice President.

Senator **Hawkins**. Thank you, Mr. Smith.

I have a few questions I will ask of each of you and I have numerous questions to ask for the record, if you do not mind, in the interest of time.

Dr. Orzechowski, in your testimony you stated that S. 1300 would only temporarily resolve the short-term solvency dilemma of the Revolving Fund at a substantial cost to the Treasury. Would you elaborate on that?

Dr. **Orzechowski.** Yes; we analyzed the plan and it looks like S. 1300 would turn to insolvency—that is, it would start eating up its assets—within 4 or 5 years and be bankrupt within 10 or 15 years.

The problem once again is simply that the long-run rate associated with S. 1300 is too low.

Senator **Hawkins.** The Chamber's recent testimony concerning amendments to the Federal Financing Bank recommended that loans and loan guarantees be subjected to the budget process. I believe you stated that you also feel that this is the way we should handle the REA program?

Dr. **Orzechowski.** Yes; it would seem that this would be an important test case for bringing some kind of oversight. Again, I think what has happened in this case—it seems to me from an historical perspective that a program with dignified goals and tremendous aims started out in terms of a situation where access to funds was mainly the issue.

The rates were equal; that is, the borrowing rate was equal to the lending rate of 2 percent. Somehow, over time, these interest rates became divergent, and this was not the intent of the Program. I think that putting this issue on budget will help.

Senator Zorinsky said there are problems with doing this sort of thing with the regular appropriations process, but we have to start doing something. What we really have on our hands is guerrilla warfare; that is, we have got special interests tucked in at many different places and what we really have to do is try to come to grips with each one of these cases and at least try to do something. So I think it is an important test case.

Senator **Hawkins.** You also spoke about the intense competition between private investors and Government agencies for capital resources. Could you provide us with an illustration of how this might occur and the impact it could have?

Dr. **Orzechowski.** Well, I think I already alluded to that. You have young homebuyers buying homes with 14 percent mortgages, and at the same time you have the co-ops getting interest rates at 5 percent.

That means that there are, on the one hand, people that are facing all the problems of high levels of Government expenditures in terms of the fact that they have to pay higher rates of interest—so-called crowding out. Then at the same time, you have another set of borrowers who can borrow at 5 percent. That, for me, creates some problems.

One set of borrowers is facing intense pressure in the capital market, while another set of borrowers is, in effect, getting an implicit subsidy. In 1981, when about 1,600 of the Chamber member auto dealers went bankrupt, in large part because they had to pay a prime of something around 20 percent or 18 percent, it was somewhat of an unusual thing to see REA loans going out for cable TV at something like 5 percent or so.

Senator **Hawkins.** S. 1300 eliminates the requirement as a condition to making a telephone loan that the Administrator make a finding of nonduplication of facilities in those States where the States do not have the authority to require the applicant to obtain a certificate of convenience and necessity.

Have you studied this?

Dr. **Orzechowski**. Madam Chairman, we did not analyze that particular issue.

Senator **Hawkins**. I recently received correspondence which cited direct competition between co-ops and private businesses. Are you aware of any instances which have come to your attention where co-ops and businesses compete for the same services, and do you believe it is a problem?

Dr. **Orzechowski**. I think this could be a problem. If we look at the customer profile of the REA, it seems to be getting much more suburban. In fact, I think there is a case in the Washington, DC, metropolitan area where the average income of the co-op users is something like $22,500.

The fact that the customer profile is getting more suburban does indicate that these heavily subsidized co-ops will be in competition with less subsidized or private IOU's. So from that perspective I think it is a problem.

According to an Inspector General study, something like 44 out of 50 co-ops were found to be in a stronger financial position than investor-owned utilities. So I think that could be a problem for the future.

Senator **Hawkins**. Senator Zorinsky, do you have questions for Dr. Orzechowski?

Senator **Zorinsky**. Yes; I would like to refer to a comment you made in your statement indicating that S. 1300 forgives the outstanding debt of the REA Revolving Fund. I think some people might misinterpret that statement to mean that the Federal Government will be giving away $7.9 billion.

The facts are that the REA is a Federal agency and that the assets of the REA Revolving Fund remain under the absolute control of the Federal Government if S. 1300 is enacted. Even though some people may say that that is not the best investment for the taxpayers' money, I would maybe say that the same claim could be made about industrial development bonds.

Are you for doing away with industrial development bonds because it is a subsidization to private sector expansion?

Dr. **Orzechowski**. I cannot really speak on industrial development bonds. That is a policy developed by our policy board and I cannot really discuss it.

Senator **Zorinsky**. Well, I would say if you opposed industrial development bonds, you would lose half your membership. [Laughter.]

If you did not know that, you should. Having been a businessman for 23 years myself, you know, I found a lot of things that do not pay their own way. I admire you and support you and respect you as a citizen and as taxpayer. The people in this country are entitled to get a dollar's worth of value for the taxes they pay.

But I would like to point out that in no way does the Interstate Highway System pay for itself. In no way does the park system in this country pay for itself. And never will the rural areas of America make their own way because of the fact that the average area served in the rural areas when it is fully developed has one-third the density of the urban area.

As you are well aware, the fact that more people can be served with less transmission of energy, the more economical and the higher degree of profit that is generated for the company doing the selling of that energy.

I just would like to point out that there are very few farms that could actually pay the cost ascribed to the bringing of a transmission line and the work required to amortize all of that economics. It would be unaffordable, it would be confiscatory; there would be no way they could have that service.

I think that is what makes this country unique. The urban areas help offset the rural areas and there will always be some sort of subsidization. I think you probably hit on the whole essence of the situation—priorities. Are we going to maintain priorities in our taxing system to give advantages to the private sector with tax shelters?

I am not going to enumerate them because we will be here the rest of the day. That is one reason I admire the administration for supporting a flat tax rate; it is about time. Maybe once every 50 and 100 years we go back and eliminate all the loopholes.

But let me say this: the loopholes are not all in REA. The loopholes are numerous in many other areas, and I think if we are going to do this to the rural areas by increasing the electrical energy rates to such an extent that we will leave some people without it, we should make it equitable for everybody across the board and do the same thing to all other enterprises, private and federally owned in this country.

I admire your basic logic in the fact that we ought to curtail the expenditures and have a greater degree of accountability. But, also, at the same time if it were not for airplane manufacturing and agriculture, this country would not have much of anything to export to the rest of the world. And I would hate to start with the agricultural sector of this country and destroy it first by making unaffordable energy rates.

They use that a lot in irrigation. We have got 40,000 irrigating units in the State of Nebraska alone which require energy to use those pumps to lift the water out of the ground. Farmers do not all drink that water. They grow crops for the people of America to eat food so we do not have internal revolutions and so we can turn around and send $8 billion to Central America.

If we cannot maintain the people in this country through a viable rural economy and sector and continue a growth factor—you know, talk to Con Edison; they are always looking for ways to offset with Government enticements and loopholes and tax shelters the sale of their bonds.

The Omaha Power District is not an REA, but their tax-exempt bonds—take that away from them and see what happens to electric rates. So I say, you know, we are singling out an area of REA, and as much substance or no substance as there may be to the argument that you present, certainly it is not in keeping with the overall concept of—I can tell you where we can find $150 billion a year in reducing deficits.

Everybody knows where it is, and I have already voted for it, and that is curtailing the cost of living in entitlement programs, you know, if you want to talk about reducing deficits in budgets. But I am not going to get into that because that is not what this hearing is all about.

Thank you, Madam Chairman.

Senator HAWKINS. Thank you, Senator.

Mr. Smith, in your opinion, what impact would this legislation have upon American businesses in general, across the board?

Mr. SMITH. I think that to the extent that American businesses are very concerned about the economy, this is a continued step toward out-of-control Federal spending and it is a continuing step toward displacing the private capital markets and sending interest rates up.

All of that, America's businesses are concerned, would have a detrimental impact on the economy.

Senator HAWKINS. Are you aware of any instances where co-ops are in direct competition with private businesses?

Mr. SMITH. I am not aware, Madam Chairman, of those instances, although I have heard some of the classic cases. But I am not that familiar that I can testify directly to them. Our members, who are also REA constituents, have somewhat sheepishly told us that they do enjoy much better rates as far as their electrical rates than some immediately adjacent areas that are served by private, investor-owned companies.

Senator HAWKINS. We know that the Chamber prefers the Bethune bill. Do you believe that S. 1300 is a good means to achieve some sound financial standing in order for co-ops to become financially independent?

Mr. SMITH. S. 1300 or the Bethune——

Senator HAWKINS. S. 1300. I know the Chamber prefers Bethune. How do you feel about S. 1300?

Mr. SMITH. Well, to the extent that I have testified against S. 1300, I find that one of the classic attributes that I left out on this bill is its title, the self-sufficiency bill, because that is about the only thing in the bill that has to do with self-sufficiency.

Madam Chairman, I do not think it would make REA self-sufficient.

Senator HAWKINS. Thank you, gentlemen, for helping to build this record today and we will excuse you at this time.

We will next call Dr. Joe Pace, who is the senior vice president of NERA, [National Economic Research Associates, Inc.]; Jack Doyle, director of the agricultural resources project of the Environmental Policy Institute; and Jill Lancelot, congressional affairs director of the National Taxpayers Union.

Dr. Pace, we will hear from you first.

STATEMENT OF DR. JOE D. PACE, SENIOR VICE PRESIDENT, NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.

Dr. PACE. Yes; thank you. My name is Joe Pace and I am an economist and a senior vice president of National Economic Research Associates. Here in the room with me today is Dr. Martin Fullenbaum, who worked with me in developing our analysis.

I will now give a summary of my statement.[1]

Senator HAWKINS. Please.

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[1] See p. 340 for the prepared statement of Dr. Pace.

Dr. **Pace**. I have been asked to appear today to address a background issue that has been advanced as important in considering S. 1300, and that issue is whether the Federal subsidies now being provided to investor-owned utilities, or IOU's for short, are greater than those now being provided to rural electric co-ops.

Over the past several years, the National Rural Electric Cooperative Association has been making such a claim. The co-op association's latest study suggests that on a per customer basis, IOU's receive over five times the Federal subsidy received by co-ops.

In the remainder of this statement, I will discuss the co-op association's findings and contrast them with my own, and I will conclude with just a few limited comments on the public policy implications of the differential in Federal subsidies provided to various sectors of the electric utility industry.

First, let me go straight to the bottom line. The most recent co-op association study concludes that in 1981, which is the year they looked at, co-ops received Federal subsidies of only about $9 per co-op customer, while the subsidy to IOU's amounted to over $50 per customer.

Thus, according to the co-op association, the IOU subsidy was over five times the co-op subsidy on a per customer basis.

Now, it is extremely important at the outset to recognize just what the co-op association is measuring. Its analysis focuses on Federal subsidies provided to co-ops only in connection with new insured loans—that is, the direct, essentially 5 percent loans—extended to co-ops in the year 1981. Thus, it does not tell you anything about the total amount of subsidies provided to co-ops in 1981, which results from the cumulative effects of loans made to them over a number of years.

Beyond this, the co-op association analysis measures only a single year's subsidy provided in connection with the 1981 loans. It makes no effort to measure the total subsidy that will be provided over the life of those loans.

In sum, I must say frankly that from my point of view, the co-op analysis does not measure anything very relevant; that is, it cannot tell you anything about the total amount of Federal subsidies provided to co-ops in 1981, and it cannot tell you anything about the increase in Federal subsidies that can be expected to result throughout the life of the loans made in 1981.

In sharp contrast to the co-op study conclusions, my analysis shows that the additional Federal subsidies extended in connection with new 1981 investments by co-ops and IOU's can be expected to amount to $47 per co-op customer and to $15 per IOU customer during each year of the life of those investments.

Thus, I reach virtually the opposite conclusion from the co-op association; that is, that on a per customer basis, I conclude that co-ops receive three times the Federal subsidy extended to IOU's in connection with 1981 programs.

I have also analyzed 1983 data—these have recently become available—to see how the relative subsidy situation may have changed. I find that the additional Federal subsidies extended in connection with 1983 co-op and IOU investment can be expected to amount to about $41 per co-op customer and about $14 per IOU customer, and again that is during each year of the life of those investments.

Thus, although the gap narrowed slightly between 1981 and 1983, clearly on a per customer basis co-ops continue each year to receive additional Federal subsidies far in excess of those provided to IOU's.

Beyond this, it is extremely important to look at the subsidy measure that the co-op association never addresses; that is, what is the total Federal subsidy currently being provided to co-ops and IOU's.

Based on data for 1982, which is the latest year offering complete information, my analysis shows that as a result of Federal programs, co-ops were provided with subsidies amounting to a net advantage over IOU's of $160 per customer.

In sum, in my judgment there is simply no question that co-ops continue to enjoy a very sizable subsidy relative to that provided to IOU's.

Let me just touch quickly upon the principal disagreements I have with the co-op association analysis. First, that analysis measures only the out-of-pocket costs borne by the Federal Government in connection with the 5-percent direct loans provided in 1981.

The co-op association approach attributes no value whatsoever to the additional $4.4 billion of guaranteed loans extended to co-ops in 1981. In my view, a comprehensive analysis of the relative subsidies provided should compare the interest rate paid by co-ops on all loans received in 1981 with the cost incurred by IOU's to raise capital in 1981.

The logic behind this is that because the co-ops and the IOU's are essentially in the same business, if the co-ops had to raise capital in the private market rather than receiving the bulk of their funds through Government loans, they could expect to pay at least as much for new capital as do IOU's.

The benefit conferred on co-ops by Federal loan programs thus is equal to the difference between the co-ops' total interest cost and what their capital cost would be at IOU levels, which was about 16 percent in 1981.

If you compare the co-ops' interest cost to the IOU capital cost, that more than doubles the measure of the co-op subsidy to something like $20 per customer.

The second major disagreement I have is that the co-op analysis fails to attribute any subsidy to the fact that the co-ops pay no Federal income taxes. Yet, at the same time they count any reduction in IOU tax liability as an IOU subsidy.

The co-ops' current zero Federal tax cost should be compared with the tax burdens they would be expected to bear if they raised capital in the private market and paid full Federal taxes on that income, as would be required by private financing. Recognizing the taxes not paid by co-ops raises the subsidy calculation to $48 per co-op customer.

The co-op association analysis fails in another important respect to produce co-op and IOU calculations which are comparable. The co-op calculation is produced by looking only at the first-year subsidy associated with 1981 loans. Looking at first-year subsidies does not provide a reasonable basis for comparison, however.

This is because the co-op subsidy will persist at essentially the same level during each year of the life of the loans extended in 1981. But in contrast, the investment tax credit and accelerated depreciation subsidies provided to IOU's in connection with 1981 investments will decline every year and, in fact, will reverse after year 15.

After the first year, for example, there is no investment tax credit to reduce IOU tax liabilities, and after the second year tax benefits yielded by accelerated depreciation decline continuously.

To produce comparable numbers, then, the relative subsidy must be expressed on a level annual basis. When this is done, the co-op subsidy is found to be $47 per customer, while the IOU subsidy is $15 per customer. Now, let me explain exactly what that means.

What this means is that the Federal subsidies provided to co-ops in connection with 1981 investments were sufficient to reduce their costs by $47 per customer during each of the 35 years of the loan life. In contrast, the tax benefits resulting from the use of accelerated depreciation and investment tax credits were sufficient to reduce IOU costs by only $15 per customer during each of the 35 years of their 1981 investment.

Fourth, as noted above, the co-op association never addresses the total subsidy currently provided to co-ops and IOU's. My analysis reveals that in 1982, the co-ops enjoyed a net subsidy advantage of $160 per customer; $120 of this resulted from Federal Government loan program and the forgiveness of Federal income taxes.

An estimated additional $40-per-customer subsidy resulted from granting co-ops preference to low-cost power marketed by Federal marketing agencies.

Let me conclude with just a couple of brief comments on some of the effects of the relative subsidies provided to co-ops and IOU's.

First, anytime the price of a good or a service is subsidized, it will be overconsumed from an economic point of view. Net subsidies provided to co-ops lead to underpricing the electricity they sell. If you underprice electricity, people will overuse it.

In an age when so much public policy is directed toward discouraging inefficient use of energy, the effects of all energy subsidies provided by the Federal Government deserve reconsideration.

Second, my own view has long been that a large part of the antitrust difficulty this industry has experienced in the past decade has been directly attributable to the subsidy. Co-ops and IOU's have engaged in protracted litigation aimed at determining the IOU's antitrust obligation to share benefits with co-ops.

IOU's naturally have been reluctant to share all of the advantage of their large size with rival co-ops who have an important competitive edge as a result of Federal financing programs. Were the relative subsidy reduced, the antitrust problem might well go away.

Finally, the most recent concern with the subsidy grows out of the debate regarding deregulating electric generation. The view that the generation of electricity is no longer a natural monopoly requiring regulation is being heard with increasing frequency.

This leads to the suggestion that electric generation should be furnished by unregulated, competitive companies. But if publicly owned and cooperative utilities still are free to build generating facilities, and if they are provided with subsidized capital to do so, the deregulators' vision of a competitive generating industry might be translated into a publicly owned and cooperative monopoly.

Thus, the continued provision of unequal subsidies to various sectors of the electric utility industry will represent a major stumbling block to further considerations of partially deregulating the industry.

Thank you.

Senator HAWKINS. Thank you, Dr. Pace.

Mr. Doyle, we welcome you back.

Mr. DOYLE. Yes. Madam Chairman, I wondered if it would be OK to move to the next person because I am waiting for some revisions in my statement.

Senator HAWKINS. All right.

Mr. DOYLE. We had some problems with our word processor this morning, and I apologize.

Senator HAWKINS. Ms. Lancelot, could we hear from you?

STATEMENT OF JILL LANCELOT CONGRESSIONAL AFFAIRS DIRECTOR, NATIONAL TAXPAYER'S UNION

Ms. LANCELOT. Well, I just want to say, Jack, I understand that. I rushed up here myself, pulling it from the word processor.[1]

I want to thank you for giving us this opportunity to testify. Let me tell you who I am. I am with the National Taxpayers Union. We are the largest nonprofit group representing the taxpayer and we are dedicated to lowering taxes and to ferreting out the waste in Government spending.

Today I am accompanied by Cesar Conda, who is the director of Government Affairs for the Competitive Enterprise Institute. Fred Smith was supposed to be here, but he is out of town and he sends his regrets.

We are concerned with the fiscal impact of S. 1300 and the fact that it passed the House with a wave of the hand, with hardly any scrutiny, no questions asked. But I guess considering that this is an election year and that rural electric co-ops operate in about 46 States, it is not surprising that it did pass the House by an overwhelming majority. We are looking to the Senate to reverse that action.

Although there is a hue and cry heard all over the Hill and beyond that we must control deficits, we still see bills such as this passed without a murmur of protestation, and that leads me to just briefly tell you and mention the National Taxpayer Union effort to pass a constitutional amendment to balance the budget.

I must confess that I for many years prior to this questioned the wisdom of such an amendment, but I am now firmly convinced that it is the only solution to controlling the bias toward spending that we see going on today. A balanced budget is the only means by which to control those special interests that seem to exploit the vulnerability of Congress toward spending, yet at the same time not jeopardize the legitimate priorities of Government spending.

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[1] See p. 359 for the prepared statement of Ms. Lancelot.

S. 1300 is a classic example of how the special interests turn a piece of legislation into an emotional issue and lead one to believe that it is for the good of the country and that unless this passes, lights are going to go out all over rural America. We feel that nothing is farther from the truth.

Now, I will just briefly summarize why we oppose this bill. We feel that the forgiving of the $7.9 billion, which we feel is a tremendous sum of money, is not going to keep the Fund from insolvency.

Harold Hunter, who is the Administrator of the REA, who testified before the Agriculture Committee in the House, also testified that this forgiveness is not going to keep the Fund from insolvency—that the shortfall in the Fund will continue.

The second point is that we feel S. 1300 creates a dangerous precedent. It legitimizes the off-budget appropriation and we have always objected to that back-door approach to financing because it lessens Congress' ability to control the Federal budget deficit.

If the action is truly needed, then we feel that Congress ought to be up front about it and use the on-budget process and stop hiding the true cost to the taxpayers.

The third point is that the need for permanent forgiveness is questionable considering that the Fund is capable currently of repaying that loan.

The fourth point is that we feel that S. 1300 hardly insures the self-sufficiency of the Fund. Although it raises interest rates, the rates would still remain below the borrowing cost, and therefore the interest expenses would overtake the interest income. And once again, Congress would come back and be asked to provide a new remedy for the shortfall that we would see.

The last point of why we feel this should not be passed is that the enactment of the bill would forgo the opportunity to rethink the appropriate role of the REA.

Let me just sort of mention that the reason we think that the REA goal should be questioned at this time is we feel the time has come to clarify the goals of the REA, reexamine the criteria used to determine the subsidies and the beneficiaries to whom those subsidies are intended.

As mentioned before, the role of the REA has changed. As mentioned before, 99 percent of rural America is electrified, and 95 percent has telephone service. We are not suggesting that those truly in need should not have this opportunity to have telephone service and electricity at reasonable rates.

That certainly is a legitimate function of the REA, but a lot has changed since the 1930's and much of rural America has become suburban, and in some cases even urban. Often, the co-ops are providing taxpayer-subsidized power to suburban, commercial and industrial users, not to the small farm and rural households that the REA was intended to serve.

I think that pretty much sums up the text of my testimony, but I would like to say in closing that this bill transforms one of Government's most successful programs into what amounts to a new entitlement program. This entitlement program would benefit the REA ratepayers at the direct expense of current and future taxpayers.

Senator **Hawkins**. Thank you, Ms. Lancelot.

[The following answers to questions of Ms. Lancelot from Senator Hawkins were subsequently received by the subcommittee:]

Question. Do you believe that S. 1300 would allow the fund to become self sufficient?

Answer. No, S. 1300 will not aid in the solvency of the Fund. As I mentioned in my prepared statement, REA administrator Harold Hunter stated that the forgiveness of the $7.9 billion loan would not keep the fund solvent.

Furthermore, although the proposed legislation (S. 1300) does contain a formula to raise interest rates, it raises them from five percent to only about six percent. Since Treasury borrowing is about twice that figure, it only stands to reason that a shortfall will remain. We believe interest rates should be based on the cost of money to the Treasury. One can not borrow high and lend low and expect to remain in the black.

Question. Do you have any suggestions on how to solve this problem, other than S. 1300?

Answer. The REA bill has received inadequate attention in Congress and deserves further discussion. There is no immediate need to act on this issue—the lights will not go out in rural America. In fact the "crisis" is several years away and could be deferred by minor changes in the current interest rates and lending policies.

We would like to see the following alternatives:

REA outlays should be limited to REA income;

Interest rates on the loans should be increased to equal the Treasury's cost of borrowing;

the $7.9 billion loan should not be forgiven;

exclude the nonrural systems and projects, which were never the intent of the original legislation, but are currently being served by the REA; and

target the subsidies to borrowers who demonstrated need, rather than allowing the subsidy to benefit all rural electric borrowers regardless of need.

Question. A number of witnesses have stated during this and other hearings that this is the time to reevaluate the entire REA program. Do you agree with this assessment?

Answer. Yes we do. REA was established fifty years ago under extremely different social circumstances than now exist. Much of rural America has become suburban and in some cases even urban. In too many cases REA has wandered away from its original mandate to bring electric and telephone service to small farms and rural households not likely to be serviced by private utilities oriented to the more populated, and more profitable, urban areas. REA has gone far beyond its clearly defined mission of distributing power, and become a financer of and investor in power production, using below market federal funds. REA's artificially low interest loans are skewing energy market decisions by subsidizing projects that Wall Street has deemed financially unsound. The delivered electricity does not reflect its real, higher, cost, leading to excessively wasteful consumption.

Senator HAWKINS. Are you ready, Mr. Doyle?

Mr. DOYLE. Well, I have an abridged statement here. The other one is still on the way, so I will not take up any more of the subcommittee's time.

Senator HAWKINS. You can just give us a summary of what it is going to say and we will submit the full statement for the record.[1]

STATEMENT OF JACK DOYLE, DIRECTOR, RURAL LAND AND ENERGY PROJECT, ENVIRONMENTAL POLICY INSTITUTE

Mr. DOYLE. For the record, Madam Chairman, my name is Jack Doyle and I am director of the Agricultural Resources Project of the Environmental Policy Institute. EPI is a nonprofit organization engaged in research, public education, litigation and lobbying on a range of energy, natural resource, and public health issues.

We are here today not to focus on the financial nuances of the Rural Electric Revolving Fund, but rather to point out some of the underlying reasons why co-op financial needs have been ballooning out of control in recent years.

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[1] See p. 362 for the prepared statement of Mr. Doyle.

In September 1979, we released a comprehensive study of the REA and the rural electric cooperative system, entitled "Lines Across the Land." Although it is 4 years old, we feel that it still represents a very good analysis of some of the problems in the rural electric system, and we feel that it has helped Congress and other Federal agencies in examining the rural electric system from a different point of view.

One of the interesting things we discovered in 1979 was that REA financing was being used to help investor-owned utilities build new nuclear and coal-fired powerplants. We discovered then, for example, that some 37 G&T co-ops, and more than 50 local co-ops in one case, were directly involved with investor-owned utilities and 58 joint ventures; 34 of these ventures were nuclear power projects.

One particularly disturbing aspect of this new partnership to us, both then and now, is the merging of a quasi-public entity established in part to provide a clear measure of the true cost of electric power with private sector interests. One could argue that when the co-ops crossed this line, they also left behind their charter and the changes were no longer indicative of the kind of financing that they needed.

In fact, we found that the rural electrics were bringing public financing to the private sector. Nucleonics Week saw this as early as 1976, noting that the IOU's saw the co-ops as a cheap source of money and a system which had a rapidly rising demand for electricity.

This new partnership between the REA and the IOU's has changed the landscape of utility politics as well. As again Nucleonics Week noted in 1976, and I quote from Nucleonics Week in that year,

> One source closely associated with the nuclear industry said rural co-ops are considered first-class allies and they have a hell of a lot better credibility than private utilities.
>
> They reach a class of voter, typically farmers and ranchers, different from the urban and suburban consumers affected by private utilities.

This change in politics of REA co-ops in joint unison with the investor-owned utilities has on occasion reached right into the White House in terms of policy changes and lobbying for policy changes.

For example, on April 1, 1982, the president of Gulf States Utilities Co., Norman Lee, wrote a letter to Vice President George Bush asking him to help obtain approval of a $125 million REA loan guarantee for the Sam Rayburn G&T co-op. That co-op was planning to buy a 7-percent share of Gulf States' River Bend nuclear plant being built in Louisiana.

The text of the letter from Lee to Vice President Bush read in part:

> Recently, you visited with several electric utility chief executives who asked for your help in two critical areas, financial and nuclear. Gulf States offers a classic example of the dilemma confronting our industry.
>
> We are wrestling with the financial-nuclear problem which is being exacerbated by the Rural Electrification Administration. I sincerely request the support of your office in setting approval of the loan guarantee application which has been submitted by Sam Rayburn G&T, Inc., in Jasper, Texas.

> This loan guarantee would enable the cooperative to purchase 7 percent of the River Bend powerplant being built by Gulf States in Louisiana. We have had several meetings with the REA Administrator and his staff to urge their approval of the application, but we recently learned that REA does not intend to approve the application.
>
> If this position becomes final, it will place an additional financial hardship on Gulf States and will jeopardize the model national labor agreement in effect at the River Bend construction site. Also at stake are more than 4,000 jobs which River Bend is now providing for the construction workers and others who are building the facility. A brief summary of the events leading up to the present time is attached.

This is still in the body of the letter:

> I earnestly hope that you and your staff will meet with us in the near future in the effort to help Gulf States and its 500,000 customers to find a solution to this important problem.

And as far as we can determine, and to the credit of the Reagan administration, this loan was not approved. But this provides, I think, an interesting example of how 30 years ago you would not have found the investor-owned utilities and the REA cooperating in this way, and moreover not lobbying the White House to ask for a loan approval on an REA loan for an investor-owned utility project. I think it is indicative of the change that has occurred in the last 20 years.

Senator HAWKINS. May I interrupt you? I have been called to another meeting at this point to make up a quorum. We will have about a 20-minute recess.

(A brief recess was taken.)

Senator HAWKINS. Mr. Doyle, we will continue with your statement. I see it is here.

Mr. DOYLE. I wanted to add a word about some of the nuclear ventures that the rural electrics are involved in. At last count, seven of the nuclear projects in the most danger of abandonment or bankruptcy in the near future are projects in which REA co-ops are involved.

We have recently witnessed the so-called WPPSS project in the Northwest, and now Seabrook seems to be teetering on the edge of bankruptcy. These are two of the most recent casualties. We ask how many more nuclear projects in which the rural electrics are involved themselves are in financial trouble. How many are headed for bankruptcy?

Of the co-op nuclear ventures that are actually producing power, how many are providing cheaper electricity, even accounting for inflation, than they were before those projects came on line?

And what about waste and decommissioning costs in the future? Will Congress in the not-too-distant future once again be asked to ante up a few million more for the co-ops' share of waste disposal and decommissioning at the 30-odd nuclear ventures in which they are now involved?

How many of these projects might be worth walking away from right now before the losses and future encumbrances mount to astronomical levels for rural ratepayers?

We respectfully ask that this subcommittee and other agencies of Congress investigate each of the REA co-op nuclear ventures now to determine what actions, in the interest of saving Federal dollars, could be taken to minimize future costs.

Another question related to the financing demands in the REA system has to do with rates and rate structures and who gets power and at what cost. Who is the REA serving with its federally supported electrical system? Is it serving the isolated family farmstead in rural Montana and the families in hard-to-service Kentucky hollows, or is it increasingly geared to serving big agri-business, big industry and big recreation?

Moreover, are the rates that rural residents and family farmers pay equal to those that big industrial users pay? If the REA's current financial difficulties are in any way the result of a rate structure or servicing favoritism that subsidizes big power users at the expense of rural residents and family farmers, then someone in the REA hierarchy should be held accountable for that misplaced emphasis and corrective adjustments should be in place before any further benefits are extended.

In "Lines Across the Land," we found a pattern in some co-ops of huge blocks of power being sold to large industrial and commercial users. While co-op electric sales to large industrial and commercial users nationwide average about 22 percent, in 11 States, 9 of which are in the West, industrial and commercial users consume between 25 percent and 67 percent of rural electric sales.

In our study we found that co-op electric power was going to some of the Nation's very largest companies at considerably reduced rates, and we suspect that pattern has not changed much since 1979.

In Alabama, for example, we found co-ops selling power to service pumping needs in the oil and gas field; in Arizona, to Phelps Dodge and Anamax Mining for mining and milling; in Colorado, to Shell and Chevron for pipeline pumping; to Union Carbide for uranium milling; and to others for coal mining.

In Kentucky, for example, the Big Rivers Electric Co-op of Henderson sells about 80 percent of its power to Anaconda Aluminum and National Southwire. In Illinois, the co-ops sell power to Shell pipelines. In New Mexico, they sell to Kaiser Steel coal mines, and the list goes on and on. In Wyoming, in one co-op, 90 percent of the power is sold to large industrial and commercial users, but that co-op still qualifies for 2 percent REA loans.

It would be interesting to examine those co-ops with high industrial and commercial users to see which ones have had large rate increases in recent years and how those rate increases were apportioned among all users.

When we began our study of the REA's in 1978, we were not sure what we would find. Because of their New Deal charter and their origins in the progressivism of the co-op movement and agrarian populism, we expected the REA co-ops to be progressive in energy, environmental and agricultural policies, but we were wrong.

At some point in the REA's history—I would say about 1970—progressivism went out the window and protectionism and empire building came in.

We expected, for example, that a cooperative system run by its members would want to do good deeds for the rural environment in which it operated, while supplying reasonably priced electricity. However, we were wrong.

Rural electrics have one of the worst environmental records and policy platforms in the country today. For example, in our study we found that rural electrics took the following positions: supported the amendments to the Clean Air Act to delete the "no significant deterioration" clause; supported a limitation on legal actions under the National Environmental Policy Act; supported amending the Endangered Species Act to exempt certain species; opposed expanded wetlands regulation; opposed the point source designation for water impounding dams; opposed President Carter's proposal to delete funding for 23 water projects that were objectionable on economic, safety, or environmental grounds.

In addition, among the environmental laws frequently mentioned or listed by NRECA, State co-ops and co-op publications as troublesome or obstacles to co-op progress and every environmental law ranging from the Clean Air Act of 1977 and the strip-mining law of 1977, to the Refuse Act of 1899 and a list of others.

What about farmers? When it comes down to a choice between protecting farmers and agricultural resources or a rural electric project, where do the co-ops come down? In the summer of 1977, for example, the Basin Electric Power Cooperative of North Dakota urged Members of Congress not to adopt provisions in the Federal strip-mining law for protecting prime farm lands, alluvial valley floors, and western landowners.

Rural electric cooperatives building powerplants with large water requirements in Wyoming, Kansas, and several other States have begun to compete with farmers and ranchers and local irrigators for limited water supplies. Co-ops fighting for scarce water in Wyoming and Kansas have purchased ranches outright to acquire their water rights, have gone into court seeking no-loss transfers of in-stream water, and have proposed pumping underground water sources to such an extent that stream flows, water tables, and local agricultural wells could all be adversely affected in the future.

G&T co-ops building power lines have used eminent domain and threats of eminent domain to acquire easements and rights-of-way in Wisconsin, Wyoming, Minnesota, North Dakota, South Dakota, and several other States.

Co-op members in North Dakota, Indiana, and Minnesota have charged G&T co-ops with misrepresentation over the use and threatened use of eminent domain power to acquire rights-of-way and powerplant sites.

In North Dakota, more than a dozen affidavits were filed with the consumer fraud division of the State attorney general's office by farmers and ranchers who were subjected to questionable tactics by G&T right-of-way agents during 1975 and 1976.

I think an important question here is what are the rural electrics doing about the farmer's cost of production. How are they helping minimize the farmer's cost of production through energy? What have the co-ops done in the way of energy conservation, solar, wind, or other innovative approaches to help the farmer reduce his costs so that he can reap a better return and stay in business?

Hopefully with Bob Bergland now at the helm at NRECA, the cost-of-production side of agriculture will receive more attention from the co-ops.

How are the co-ops treating their own members and the rural community? For example, how is REA doing—and here I mean the whole REA system, from local co-op boards of directors to G&T management and officers—how are they doing in affirmative action programs?

Are local co-op boards really representative of the people they serve? What about G&T boards? Do they reflect the farmer, the rural poor, women, and racial minorities in their local jurisdictions?

In news stories attached to this testimony, there are accounts of gross underrepresentation of racial minorities in local co-op boards. Testimony we gave before this subcommittee in 1981 enumerated some of the problems co-op members were having participating in what they thought were internal democracies.

What we found in "Lines Across the Land" is that co-op philosophy, as applied to the rural electric system, has been turned upside down. Instead of being a democratic, grass-roots, bottom-up system where policy is derived from member to manager, rural electric cooperative policymaking begins at the very apex of the system, at the G&T level, and is force fed downward to managers, directors, local board members, and ultimately consumers, through a wide assortment of techniques.

One way to help co-op members have a more direct say in policy formulation where it counts would be to have direct co-op elections for G&T boards. I think that distinction is important that direct elections for G&T representation be considered as a management practice because in some cases we have discovered that for some of these nuclear projects, for example, the body of the membership seems to have been ahead of the management in seeing the problems ahead. I think direct representation of people on those boards would help provide better representation.

I would like to say a word about energy conservation in the co-op system and to use a turn on a phrase now made popular by Wendy's hamburger chain and Walter Mondale. I ask REA and NRECA, where is the conservation?

In fact, I would hope that Walter Mondale asks that question of the co-ops himself as he campaigns in the western primaries. Failing that, then Gary Hart has a perfect opening for a "new idea."

The best new idea, however, is not a new idea at all. It is as old as the Arab oil embargo, now more than 10 years old itself. But what have the REA co-ops done in energy conservation since that time?

In "Lines Across the Land," we noted several examples of REA co-ops involved in energy conservation and renewable strategies, from the Energy Conservation Cooperative Corporation in Arkansas to the cash bonus home insulation incentive used by the Coles-Moultine Co-op in Illinois, used there since 1963.

These are examples in our mind that suggest that conservation and renewables can, in fact, be accomplished within the REA system. Yet, sadly these examples are the exception rather than the rule.

The proof of energy conservation, had a crash program been unleashed by the co-ops in the midseventies when we saw that we were in trouble energywise, would have been to drastically lower

Federal outlays for REA in the mideighties. Yet, the co-op leadership did not embrace energy conservation. In fact, they outright resisted it.

"Lines Across the Land" documents the sad and disappointing story of how the REA and the NRECA did not promote a Carter administration low-interest home weatherization program. By May 1980, in fact, REA Administrator at the time, Robert Feragen, admitted to the failure of that program before this subcommittee.

Has the Reagan administration done any better with REA energy conservation since then? Since the Arab oil embargo, REA loan guarantees for electric distribution lines, high-voltage transmission lines, and powerplants have totaled more than $30 billion.

However, REA loans for energy conservation and home weatherization have comprised no more than 1 percent of total REA financing in the last 10 years. This wide gap between high electric growth expenditures on the one hand and very low energy conservation expenditures on the other has contributed, in our view, to the very large demands on Federal borrowing.

While REA and some local cooperatives have moved forward in good faith to try to improve the co-ops' energy conservation record, REA programs have generally failed for three reasons. They are not mandatory, they are not tied to clear energy conservation goals, and they are aimed at the wrong level.

REA energy conservation programs need to be directed at the 50 to 60 G&T co-ops, not the local co-ops. Aimed at the G&T co-ops, with clearly stipulated energy conservation goals and required as a condition of continued access to the Federal Financing Bank for loan guarantees, would have the effect of coordinating local co-op conservation programs throughout the Nation, while at the same time reducing the amount of off-budget financing needed for new REA powerplants.

Such a requirement, in our view, would help coordinate local co-op conservation programs within G&T systems, would promote jobs in home weatherization and other energy conservation businesses throughout rural America, and would help reduce the amount of off-budget borrowing needed by REA.

A 1-percent reduction in electric demand by a G&T system would save millions of credit dollars in Federal borrowing, freeing up that capital for other uses throughout the country.

It is now said by the co-ops that there is excess capacity in their system, and some members of the co-op leadership are again talking about promoting electric use. If there is excess capacity in the co-op system today, the goal should not be to promote electric use, which will entail still more need for plant construction in the future and more financing, but rather to use that margin as a planning buffer to implement systemwide energy conservation and renewable strategies.

One of the reasons why the REA's are in financial trouble today is because they did not broaden the base of their energy portfolio with diverse energy options in times of rising energy prices. Instead, they put all of their eggs and our dollars into the basket of centralized power—big coal and big nuclear.

The co-ops should have taken a lesson from any Wall Street broker and started building a diverse portfolio of solar, wind, low-head hydro, small-scale coal, and other options into their nationwide system.

Indeed, some IOU's began to do just that while the co-ops were off chasing nuclear power. Many of the Nation's largest energy corporations such at Atlantic Richfield, Exxon, and Standard Oil of Indiana have invested in solar energy and other alternative energy systems. If these investments are safe enough for the private sector, why cannot the REA's invest in these same systems, too? In fact, why were they not leading the private sector in the midseventies in these technologies?

In this regard, I would like to commend to the subcommittee's attention the most recent edition of Business Week, whose feature story asks the intriguing question, are utilities obsolete? I urge this story as required reading and as evidence of how large-scale power generation of either the coal or nuclear variety is increasingly risky and inefficient from the investment community's standpoint, and that alternatives and renewables are being embraced as the new way of energy for the future.

The Environmental Policy Institute and others have been saying that since 1974. Some of the explanation in the Business Week article from this week from respected sources in the industry and investment community are truly instructive for the future.

According to Douglas C. Bauer, senior vice president for Economic and Finance at the Edison Electric Institute, "What we learned from the 1970's is that the risk of building a large nuclear, and probably coal plant is more than a single company can bear."

Evern R. Wall, chairman of El Paso Electric Co., adds, "A large facility is a large hazard for everybody. The cycle is now to locally owned, smaller units." And locally owned, smaller units is what the REA system nationwide has plenty of.

In fact, in "Lines Across the Land," we found the Nation's rural electric cooperatives to be in a particularly ideal position to pursue small-scale energy options. Approximately 90 percent of the REA systems, 90 percent of the local co-ops—about 837 local co-ops—had a need for 50 megawatts of generating capacity or less to satisfy their annual power needs.

About 75 percent of those systems, or 704, needed 30 megawatts of capacity or less, and about 30 percent, or 278 systems, needed 10 megawatts or less. Given this available nationwide infrastructure for small-scale power, the REA co-ops, with the help of Congress and the White House, could forge a new small-scale direction for the REA system, one that might create certain incentives for new alternatives and energy-saving technologies ranging from photovoltaics and fuel cells to small-scale fluidized bed systems.

If Business Week is right and the utility industry is now in the midst of a technological sea change, this gives even more credence to what we have been saying for nearly 5 years about what the REA's should be doing and what some of the IOU's and larger corporations have been doing for themselves and their bottom lines in recent years.

Again, are the REA's and the Federal Government going to be left behind with an anachronistic rural utility system, saddled with evermounting costs, because they did not have the foresight and the gumption to forge a new direction? We certainly hope not.

In summary, the Environmental Policy Institute believes that some measure of Federal financing should continue for the REA system, but that the American people should receive some social and progressive energy dividends in return for that support.

We believe that the present review of the solvency of the REA fund and off-budget allowances ought to include a broad and detailed look at energy conservation and renewables that might cut costs.

We also see a need for a thorough examination of co-op rate structures and how those might be changed to accommodate the truly needy user. In addition, new geographic organization and reorganization of the co-op system ought to be examined for ways to save costs and help provide differential interest rates to co-op systems on the basis of need.

We thank the subcommittee for the opportunity to appear here today.

Senator **Hawkins**. Thank you very much. We are running into 12:00 and I have an appointment with the National Police Association. All the Senators are getting together on the Square with the widows of police officers, so we will have to recess at that time, but I would like to ask each of you one question and submit the rest for the record.

Dr. Pace, from your examination of REA financing of capital construction for rural electric and telephone cooperatives, have you concluded that the $7.9 billion forgiveness embodied in S. 1300 is the best way to establish the solvency of the fund?

Dr. **Pace**. I think very frankly the answer to that is I have not directly addressed the merits of S. 1300. I was asked to focus my analysis on the background issue of who receives the most subsidy, so I am not really in a position to evaluate S. 1300.

Senator **Hawkins**. You have written that there are many more financial benefits going to rural cooperatives than the present 6 percent or so subsidy from the Revolving Fund which many count as their only Federal benefit. Do you agree with that?

Dr. **Pace**. Yes.

Senator **Hawkins**. The GAO testified that the loan subsidies provided to co-ops are 2.4 times greater than the subsidies provided to investor-owned utilities. Would you agree with that? Have you reviewed the GAO testimony?

Dr. **Pace**. Yes, I have reviewed it and my numbers are generally comparable. Again, they are looking at the subsidies associated with new loans, and if you look at our 1983 numbers and express them in a comparable way, we find that the co-op subsidy is 2.6 times the IOU subsidy per dollar of capital. So our results and theirs are very comparable, although somewhat different methods are used.

Senator **Hawkins**. Thank you.

Ms. Lancelot, do you agree with the supporters of this bill that there is no cost associated with the bill, but it is merely a transfer from one Government pocket to another?

Ms. **Lancelot**. Well, yes and no.

Senator **Hawkins**. Maybe?

Ms. **Lancelot**. I do think that it is probably a transfer from one pocket to another, but the problem with that is that you are transferring from the U.S. Treasury, which is a pocket that all U.S. taxpayers have an opportunity to use, to a pocket that is only targeted to special interests.

The other problem, I think, with this is that the U.S. Treasury was expecting to get $7.9 billion in revenues and now they are not going to have that, and so there is a revenue loss.

Again, we, of course, at the National Taxpayers Union are concerned with taxes being raised. We do not feel that taxes ought to be raised when we have bills such as this. At a time when we are trying to make a downpayment on the deficit, we are again adding billions of new debt, and really what we are doing is mortgaging our future generations to pay for the mistakes of yesterday.

Senator HAWKINS. Mr. Doyle, Senator Simpson recently raised a number of issues concerning this legislation. Are you familiar with his comments?

Mr. DOYLE. Yes.

Senator HAWKINS. Do you find he has accurately and adequately portrayed or presented the issues?

Mr. DOYLE. I have read a correspondence of the Senator concerning the REA's and it was very well written, and I would say it reflects some of the views and some of the facts that we have uncovered with our study.

We are pleasantly surprised to see more Members of both the House and the Senate taking a great interest in the REA system. In 1979 when we urged the White House to take a strong interest in energy conservation in this system, we had absolutely no interest whatsoever. We started trying to raise this issue over 5 years ago and very few people saw the importance of looking at how this system could be turned around in a better direction.

Senator HAWKINS. Your testimony is very complete and you have a lot of exhibits. I thank you for that, but in all fairness to the REA's, I can recall in the late seventies Buckeye in Ohio had a unique program that I thought was innovative for conservation in that they used radio transmitters to divert the load from the hot water tank and pump it into the plant rather than building additional plant, which was quite innovative for that time for even IOU's.

Mr. DOYLE. Yes. I do want to set the record straight that at one time when this book came out, there were some people saying that we were trying to ruin the REA system with our study, and that is not the case at all.

We feel that the system has been very innovative. It has lost some of that innovation that initially came in the 1930's with their charter, and we feel that there is a tremendous opportunity out there for energy conservation, right down to the guy in the truck with the tools for weatherization. I mean, the infrastructure is there and we think that translates into enormous financial savings as well.

Senator HAWKINS. Thank you very much. We appreciate this entire panel's patience and testimony. We will excuse you at this time.

I would like to recess at this time and come back at 1:30 for 30 minutes. Thank you.

[Whereupon, at 11:58 a.m., the subcommittee recessed, to reconvene at 1:30 p.m.]

[The subcommittee reconvened at 1:35 p.m., Hon. Paula Hawkins presiding.]

Senator **Hawkins**. Back to the record.

We would like to call for the final panel of this hearing John E. Horne, executive vice president and general manager of the Florida Rural Electric Cooperative Association, located in Tallahassee, and Angus Hastings, president of Clay Electric Co-op, Keystone Heights, FL.

We welcome you both from Florida even though it is a lot colder here than there, and ask that you summarize your statements, Mr. Horne, and be ready for questions.

STATEMENT OF JOHN E. HORNE, EXECUTIVE VICE PRESIDENT, FLORIDA RURAL ELECTRIC COOPERATIVE ASSOCIATION, TALLAHASSEE, FL

Mr. **Horne**. Thank you and I appreciate the opportunity to come. My name is John Horne and I am the executive vice president of the Florida Rural Electric Cooperative Association, which is an association of 16 electric distribution cooperatives located and serving in Florida, as well as two G&T's.[1]

I think I may be at the wrong meeting. I have heard so much today about the low rates that co-ops have and the competitive advantages that we have, as well as the large industrial loads that we serve. It occurred to me that maybe we were talking about different people or a different animal.

But I would like to talk a little bit about the situation in Florida as it relates to the electric cooperatives and other suppliers of electricity that serve in Florida, and speak for passage of Senate bill 1300.

The 16 distribution co-ops in Florida as of the last part of 1983 served almost 493,000 members over about 46,000 miles of power line. This represents about 1.5 million people, which is between 10 and 11 percent of Florida's population. This 10 percent of the people we serve are located over about two-thirds of Florida's land mass, about 65 percent of the land mass.

In Florida, there is probably more diversity as to the characteristics of the electric cooperatives serving there than is found in most other areas, and I think it would be comparable to the Nation as a whole when you would look at the different cooperatives and the types of loads they serve.

For example, the number of members served by the cooperatives in Florida range from 6,500, the smallest, to over 80,000, the largest. The number of members served per mile of distribution line in Florida ranges from a low of 3.9 members per mile of line to as high as 33. The average number in Florida that we serve of members per mile of line is 10.5.

But if you could eliminate about four small geographic areas that have developed over the past 10 years, the average density would be in the neighborhood of 6 or 6.5. This compares in Florida to a density of 61 for the investor-owned utilities and 73 for municipally owned utilities. While the national average for IOU's is around 35, this shows the relative density of the different units in Florida.

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[1] See p. 326 for the prepared statement of Mr. Horne.

We are one of the fastest growing States, presently the seventh most populated. Our population in 1982 was in excess of 10.3 million, having increased in population from the 1970 census to the 1980 census by 43.5 percent. And by 1990, we are estimated to reach a population of 12.3 million persons.

Most of this growth has come and is coming from retired persons moving into the State from other areas. A large part of these are senior citizens, people on retirement, most of whom are living on retirement and Social Security—relatively limited, fixed incomes.

A part of this growth that has occurred over the past 10 to 15 years in Florida has occurred in the service areas of several of the electric co-ops. For example, the number of members served by one of our systems, the Withlacoochee River Co-op, which is located north and west of Tampa, has increased from 1973 to 1983, from 33 to 83,000 members over a 10-year period.

Lee County Electric, which is headquartered in North Fort Myers, has experienced a similar rate of growth, as has to a lesser extent Sumter Electric, which is located south of Ocala, and Clay Electric, which serves the northeast part of the State.

In each case, however, where this record growth has occurred, it has been confined to a relatively small geographic area within the larger service area of the cooperative. All of it has occurred in areas that have been served by the cooperatives continously over the past 40 years, and practically all of it occurred in areas where the only supplier of electric energy was the electric cooperative.

Most of this has been residential load. Most of it has average usage considerably less than the average usage on a monthly basis or yearly basis of the rest of the State. For example, at this cooperative that has grown so much, the average consumption per consumer per month is only between 700 and 750 kilowatthours per month, where the State average is over 1,100 per month. This complicates the problem of serving those kinds of loads.

Now, in order to meet the demand for electricity that has been brought about by this influx of people, the cooperatives in our area have had to borrow increasingly large amounts of money to buy power line and other equipment. They have had to do this in a period of high cost and increased interest rates.

The result has been an increased average investment per consumer as compared with utilities with slow or moderate growth. Because of these increased costs, rates have increased correspondingly.

In my testimony I have an example of the actual figures taken from the books of two cooperatives in Florida, one that has grown in a relatively stable area of moderate growth, and one that has been located in an especially fast-growing area.

The one that has been located in the especially fast-growing area—membership has increased by 2.5 times over the past 10 years, where there has been moderate increase in the other.

In that co-op where the increase in membership has increased so fast, the investment in plant per consumer has actually increased by one-fourth, whereas in the co-op with moderate growth the investment per consumer has actually declined in that same period of time.

Similarly, the total interest expense of the co-op in the fast-growing area has increased by six times over that 10-year period, just about double the rate of increase in interest of the co-op that has grown at a moderate pace.

The resulting annual interest expense per member in the fast-growing area has increased from $19 to $47 per member per year, which is more than double that of the relatively moderately growing co-op.

Therefore, this demonstrates that cooperatives in fast-growing areas may have a greater need for a reasonable, stable source of loans than they do in static areas.

In Florida, in addition to the 16 electric cooperatives, there are 6 investor-owned utilities and 35 municipally owned utilities. We serve about 10 percent of the population and the investor-owned and municipals serve the other 90 percent. It requires over 46,000 miles of line for us to serve 10 percent, whereas all the other utilities in Florida combined serve the other 90 percent on only 70,000 miles of line.

In Florida, since 1972 electric rates for all segments of the industry have gone up dramatically, due in large measure to the growth that has been experienced in the area and the accompanying increases in costs of materials and supplies, more capital at higher rates of interest, and increased capacity required to meet the needs of this growth.

The rates for the cooperatives, however, have been at a more rapid rate of increase than for any other segment of the industry. For example, the cost of wholesale power for the cooperatives that we buy from the investor-owned utilities has increased from $0.008 in 1972 to about $0.065 today, an increase of about 800 percent in the cost of wholesale power.

By contrast, the rates on the retail side for customers served by the IOU's have increased from about $20 to $22 per thousand kilowatthours in 1972 to about $75 per thousand kilowatthours today, which is an increase of about 375 percent as compared to 800 percent on the wholesale side.

Presently in Florida, the rates for most of the electric cooperatives are as much as $20 per thousand kilowatthours higher than the cost of a thousand kilowatthours for the investor-owned utilities. In some cases, it is more than $20 per thousand kilowatthours higher.

I was thinking about the competitiveness referred to this morning as far as these rates were concerned. We know that in each one of these three types of utilities that Uncle Sam has provided some assistance in one form or another over the years. It has been talked about this morning more than I have heard it talked about before.

We know, for example, that in Florida the total of the tax incentives that have been afforded to the four largest IOU's in Florida during 1982 in the form of investment tax credits and accelerated depreciation amounts to a little over $206 million in 1982 alone, and the accumulated total of these tax incentives through 1982, according to the FERC form one's which are filed with the Public

Service Commission and the FERC, the accumulated total amounts to almost $2 billion just in Florida.

By contrast, the total of loans made by REA to the distribution cooperatives in Florida from 1935 through 1983 amounts to only $429.5 million, of which $217 million has already been repaid, $104.4 million in principal and $113.3 million in interest.

Without debating the merits of providing tax incentives to the private utility sector, it does seem strange to us in Florida in our situation that so much attention has centered around that form of assistance provided through REA to the rural segment of the utility industry when there has been so little said of the assistance provided other segments of the industry.

You are talking about hidden-from-taxpayers, off-budget items. I suspect that the $15.1 billion in tax incentives and all that has been provided in 1981, 1982 and 1983 to the investor-owned utilities through these tax measures is probably more hidden from taxpayers' scrutiny than any other type of assistance to any other utilities.

Perhaps if we could call S. 1300 a tax incentive bill for the rural segment, it would not get so much opposition. We think, Madam Chairman, that this bill needs to be passed. We need stability in the Revolving Fund and we need an assured, continued source of loan funds.

You do not make plans in the electric business on a piecemeal basis. Those plans have to be made years in advance. We need stability. The fact is that nobody else really wants to do the job that the electric cooperatives are doing; perhaps in these few areas that have grown rapidly, but not in the areas that have not grown rapidly and where density is low and income from investment is so low.

Nobody wants to do that job. We need the tools to do it right and we think that this is one of the tools that we need. I certainly appreciate this opportunity to make this statement and I would be happy to respond to any questions.

Senator HAWKINS. Thank you.

Mr. Hastings, do you have something you would like to add to this record?

Mr. HASTINGS. Madam Chairman, I want to express appreciation to you for allowing us to testify in support of S. 1300. With your permission, I have some items that support my comments today that I would like to have included in their entirety in the hearing record, along with observations as to how we are trying to help our people cope with the rising cost of electricity.[1]

Senator HAWKINS. Surely.

STATEMENT OF ANGUS HASTINGS, PRESIDENT, CLAY ELECTRIC COOPERATIVE, INC., KEYSTONE HEIGHTS, FL

Mr. HASTINGS. I believe you will find that these three documents—a fact sheet outlining the increased differential in interest costs of Clay Electric Cooperative in Florida over a 10-year span, and supported by the 1973 and 1983 annual reports of Clay Electric—demonstrate the need for passage of legislation such as S. 1300.

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[1] See pp. 383-400 for the material referred to by Mr. Hastings.

Clay Electric Cooperative serves electricity to the rural areas in 12 counties in north central Florida with over 8,000 miles of line. Some of these counties, such as Duval, Clay, and Alachua, are among the faster growing counties, which requires new investment. However, others such as Bradford, Union, and Baker counties are among the slowest growing and most sparsely populated counties in the State.

Clay's overall density, consumers per mile of line, has grown from 7 in 1973 to 9.6 in 1983. This has been brought about by rapid growth in a few areas near large towns. Most of this growth is the result of the influx of retired persons moving to Florida, and I might say even from south Florida up to north central Florida.

Senator HAWKINS. That is true.

Mr. HASTINGS. In our co-op, most of these retired persons are on fixed, relatively modest incomes. Still, most of Clay's vast service area is rural and farm area with a density of only three or four consumers to the mile.

In the 10-year period from 1973 to 1983, the number of consumers in our cooperative increased from 47,000 to over 78,000, or 64 percent, while plant investment for the same period increased from $35 million to $98 million—over a 180-percent increase.

Annual interest cost in 1973 was $11.66 per consumer. In 1983 it was $43.90. Annual depreciation per consumer has grown from $27.68 to $46.67. We must borrow increasingly large amounts to meet the obligations to serve some rapidly growing areas while continuing to serve sparsely settled areas. We also must construct a lot of long extensions to achieve area coverage.

In 1973 Clay's retail rate was 2.3 cents per kilowatthour and was approximately 10 percent higher than our neighboring utilities. In 1983 Clay's rate was 8.3 cents per kilowatthour, and since then it has increased to 9.8 in the last month. That was 20 percent higher than the three neighboring IOU's, and 30 percent higher than Gainesville.

Madam Chairman, last week your office provided me with a copy of a letter from the Honorable Alan Simpson of Wyoming. Frankly, I was amazed at how closely Senator Simpson's objections to the legislation before you today follow the exaggerations we have been hearing from administration spokesmen about S. 1300.

As you were good enough to solicit my comments on the Senator's letter, with your permission, Madam Chairman, I also respectfully submit for the record that letter, along with our point-by-point observations in response to that letter. I believe the response I am submitting will fully and adequately dispel the allegations set forth in Senator Simpson's letter.[1]

In 1981 and 1982, as president of the National Rural Electric Cooperative Association, I recognized a problem was rising in the rural electric financing program. As such, I appointed a blue ribbon committee to undertake a thorough and objective study of the viable financing mechanisms available to the program for the future. The persons making up the membership of this committee included the most knowledgeable and dedicated people that I could find and included three former REA Administrators.

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[1] See p. 401 for the letter from Senator Simpson and p. 383 for Mr. Hastings response.

We held hearings at four different locations across the country, as well as the 10 regional meetings which NRECA held in the fall of 1982. The financing proposals which eventually became the basis for S. 1300 and H.R. 3050, the counterpart in the House, were discussed at our annual meetings in 1982 and 1983, with in-depth, open-ended panels conducted on the subject. During these sessions, administration officials were clearly in attendance and had free access to the floor to offer remarks.

No comments or suggestions were ever offered by administration officials during the period when the proposed Revolving Fund legislation was under discussion. The proposed changes in the REA, as embodied in S. 1300 and H.R. 3050, are the result of the honest effort of this committee, with input from countless other persons whose only interest was in bringing about stability to the REA Revolving Fund by voluntarily increasing the rates of interest paid by the cooperatives to the Fund, and at minimum cost to the Treasury. We think we have accomplished that in the legislation before you.

Madam Chairman, the rural people of Florida are looking to you to use your leadership with the U.S. Senate to bring about the passage of S. 1300, and to assure that it is enacted into law during this session of Congress.

In fact, the rural people in 46 of these great States are looking to you to use your influence with Senator Baker to insure that this vital legislation which is now scheduled for markup on or before June 7 will receive favorable floor action in the Senate chamber.

We appreciate it.

Senator HAWKINS. Thank you, Angus.

One of the problems in supplying electricity is in properly managing the peak flow and in encouraging energy conservation, as we have heard about in the testimony this morning.

What activities are the REA's involved in which would encourage effective load management?

Mr. HASTINGS. Senator, we are doing everything at Clay Electric that Mr. Doyle said we were not doing. We have load management. We were the first in Florida with load management.

Senator HAWKINS. What year did you start that?

Mr. HASTINGS. We have been working on it 3 years or better, but it is something like $15 or $20 million and we have been using, I believe, our own money to do some of this. We, right now have 20,000 of these little gadgets hooked up to the hot water heaters and the air conditioners.

Along with that, we have supervisory control equipment where we switch electricity from one way to the other. Now, I am not a manager, but having been around NRECA and over the country seeing these things happen—and we learned it from another co-op in Georgia near Marietta. They are doing the same thing.

But this last year with some of the weather we had, in 1 month we saved as much as between $300,000 and $400,000 because of load management and being able to reduce that peak. The other thing we have done from the very start when NEPA and PERPRA, I believe it was, went into effect, we have done energy audits free to everybody.

Along with that, we financed almost $1 million worth of these things after the audits were made that would help conserve energy. I forget how many now that is, but the first one was at 5 percent interest. I appointed a special committee that reviews those and they come before the board and then we approve them.

Senator HAWKINS. When you were president of the NRECA, did you have any information on how many REA's are involved in conservation?

Mr. HASTINGS. No; I do know that we talked it and pushed it, but it is hard sometimes. What I think brings this on is just what brought it on in Florida; it is the high cost of electricity.

I had the saddest letter you ever saw from a couple that was retired over——

Senator HAWKINS. No; I have seen the saddest letter.

Mr. HASTINGS. I am sure you have.

But I went out there myself; you know, on fixed income, and they just felt good about my coming out there, driving 30 miles to talk to them about it. But they were retired and their electric bill was killing them.

Senator HAWKINS. Sure.

Mr. HASTINGS. That was 1 year ago. I do not know what it is doing today. I have not heard from them.

Mr. HORNE. In addition to Clay, there are several others that are also in load management. Sumter has gone into it. Withlacoochee has it on two substations now. They are doing it substation by substation, where they can really control it, as well as some of the smaller ones.

Mr. HASTINGS. They have all come up to us and we have been working with them on it.

Senator HAWKINS. As you all recall, I tried to get all the IOU's to do it in 1974, 1975, 1976, 1977, 1978, and 1979.

Mr. HASTINGS. That is right, and we have been heavying up the lines, the cross arms, the insulators and everything to keep from building new substations.

Senator HAWKINS. And as I recall, I obtained the insulation that wraps around my hot water tank from your co-op because it was not available anywhere else, remember?

Mr. HASTINGS. Yes. I brought that to you from here, from the NRECA.

Mr. HORNE. The load factor for the co-ops, because of the nature of the load of the service, is among the worst in the State. Most of our loads are residential loads.

Senator HAWKINS. Sure.

Mr. HORNE. It would really help our load factor, and probably our price that we could charge to our members, if we had some of the industrial load that was alluded to this morning. We do not have any.

Senator HAWKINS. How do you feel about these situations? How do you feel about a co-op selling 95 percent of its electricity to a large commercial or industrial consumer in copper mining?

Mr. HORNE. It is a little hard for me to conceive of that in our situation. We would like to have some industrial or some commercial load that would give a better load factor just so you could manage your system better and maintain a better load factor because everybody would benefit from it.

As it is, we peak 1 or 2 times a day and then we pay capacity charges for that peak, when in between we sell very little kilowatt hours.

Senator HAWKINS. How long is your peak in a rural area?

Mr. HORNE. When is the peak?

Senator HAWKINS. Yes.

Mr. HORNE. Usually in the morning when everybody gets ready to cook breakfast and take a shower, and then later on at night at about the time when people start cooking supper.

Senator HAWKINS. Same pattern as in the city.

Mr. HORNE. And in between your valleys are low and there is very little current used, so this results in inefficient use of capacity. A good industrial load or two with a higher power factor would help that situation for everybody.

Senator HAWKINS. Anything within reason that we can do to keep rates as low as possible would be greatly appreciated by Floridians.

Mr. HORNE. That is true.

Senator HAWKINS. So you may be left with all residential users.

Mr. HASTINGS. Senator, one thing that our people might frown on, but it has been the best public relations I know of that we have had has been the margins or capital credits. We have paid back $2.3 million last year and the first of this year on part of 1974 and 1975.

Those people appreciate those checks and you ought to see what it does to the area when those checks come in from Clay Electric. That is money that they have invested in the co-op.

Senator HAWKINS. Have you raised your deposit schedule as the costs have gone up?

Mr. HASTINGS. Are you talking about deposits?

Senator HAWKINS. Yes, on commercial or residential.

Mr. HASTINGS. Yes, on both of them.

Senator HAWKINS. Do the commercial users put up a deposit?

Mr. HASTINGS. We either have that or a bond or something.

Senator HAWKINS. You have something tangible so you do not get left holding the bag.

Mr. HASTINGS. That is right. One of them can tear you up.

Senator HAWKINS. Absolutely.

Do you know of any REA low-interest loans which may have been used to finance cable TV? We heard that this morning.

Mr. HASTINGS. I heard that, Senator, and I am glad you asked. There were several people here, some from REA, and also Henry Friedman, I believe, a member of the general counsel of USDA at one time.

There has never been a cable TV loan of 5 percent made out of the Revolving Fund, according to him.

Mr. HORNE. I do not believe there has ever been an REA cable TV loan.

Senator HAWKINS. We will investigate it and see because that was a poignant point.

Mr. HASTINGS. Right.

Senator **Hawkins**. That is all the questions I have. We will leave the record open for 10 days for the other Senators if they would like to submit questions to anybody for the record.

As chairman of the subcommittee, I will enter into the record information which I believe will be helpful to the committee's consideration, as well as other documents I have been requested to submit.[1]

Everyone is reading this record, as you may know. Sometimes we end up with more questions than answers. We are trying to wrap this up so that we can have more answers than questions.

Thank you for your participation here.

Mr. **Hastings**. Thank you very much.

Senator **Hawkins**. The hearing is adjourned.

[Whereupon, at 2:00 p.m., the subcommittee adjourned, subject to call of the Chair.]

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[1] See pp. 401–452 for the material inserted by Senator Hawkins.

APPENDIX

MARCH 20, 1984, HEARING

STATEMENT OF HON. JESSE HELMS
A U.S. SENATOR FROM NORTH CAROLINA

Madam Chairman, I commend you for holding this hearing on legislation to amendment the Rural Electrification Act. I know that your experience and extensive work in this area have made you uniquely suited to guide us through this difficult task.

The issues facing us this morning have a major potential impact on the lending program of the Rural Electrification Administration. During this hearing and subsequent hearings in the near future, we will review various proposals to provide for the solvency of the REA revolving fund. Resolving the problems which will shortly confront the revolving fund lies at the very heart of the ability of the REA to make adequate credit available to its cooperative borrowers.

The issues before us are no doubt complex and in need of our careful and thoughtful review in order that we accomplish our goal of providing for a financially sound and fiscally responsible REA lending program. I support the efforts of Chairman Hawkins in providing thorough hearings where these issues can be discussed in an open and objective manner.

Through almost a half century the REA has made immeasurable contributions in improving the quality of life of our rural citizens by providing essential electric and telephone service. Therefore, I am committed to the continuation of the mission of the REA and pledge my efforts to resolving the difficulties which will hamper the ability of the revolving fund to provide the credit necessary for this purpose.

Witnesses before us today will help define the nature of the problem facing the REA and discuss proposals which have been offered to resolve them. It is certainly the responsibility of this committee to carefully consider these options in order that we report legislation that not only ensures the solvency of the revolving fund, but does so permanently in a fiscally responsible manner.

Legislation offered by the distinguished ranking member of the full committee, Senator Huddleston, and others, will be reviewed this morning. I know how much time and effort was spent in crafting this bill and I look forward to discussing it in greater detail.

The principal provisions of S. 1300 would allow for the adjustment of the interest rate of REA insured loans to maintain a balance between income and expenses of the fund. It further provides for the refinancing of certificates of beneficial ownership in order that the revolving fund have access to the lowest cost funds available. The bill would require the REA to subordinate its first lien on collateral so that borrowers could easily access private credit. S. 1300 would allow for annual approriations to cover unusual expenses to the fund involved with the making of "special rate" loans to cooperative experiencing hardship. Also, the bill would divide the revolving fund into separate electric and telephone accounts. Finally, this legislation would reclassify $7.9 billion in outstanding obligations to the U.S. Treasury as permanent capital in the revolving fund.

Obviously, some of these provisions are controversial and there is disagreement over their budgetary impact and over their long-term effectiveness in resolving the deficiencies of the revolving fund. All members will benefit from a fair and impartial discussion of all viewpoints during the Committee's consideration of this legislation.

The House of Representatives recently passed their version of this bill, H.R. 3050. Amendments were adopted both during Committee action and floor debate. I would expect similiar consideration of modifications during Senate deliberations.

As I previously stated, Madam Chairman, these issues are complicated. It is essential that we carefully review the potential impact of the proposals which will be before us today. The outstanding group of witnesses you have assembled will be most helpful in proving us with a greater understanding of the problems facing our REA revolving fund. I look forward to their testimony.

STATEMENT OF HON. ROGER W. JEPSEN
A U.S. SENATOR FROM IOWA

Since it was created in 1935, the Rural Electrification Administration has provided technical and financial advice and assistance to over 1,000 rural electric utilities and rural telephone companies. Over the years, as the times have changed, so has the Rural Electrification Administration changed to continue to aid rural development. Each change, including this one imbodied in S. 1300, is designed to enhance the rural electric and rural telephone program so that they remain viable and productive.

In the over nearly 50 years of its existence, defaults by rural electric and rural telephone borrowers have been virtually non-existant, a record unexcelled by any other financing program. During this same time, rural America has grown, prospered and become the world's leader in food and fiber production. The key to this growth and prosperity has been the ready availability of electric and communication services provided by REA borrowers. Like any growing industry, however, provisions must be made, not only for expansion but also for replacement of plant which is nearing the end of its useful life. Even though virtually the entire countryside receives electric and telephone service, the need for funds in order to replace and upgrade these services continues. To fail to recognize this need will relegate the industries serving rural America to the inevitable decay which has plauged America's auto industry and steel industry. Decline in productivity and the resulting decline in the rural economy must follow.

This legislation--S. 1300--takes a very large step toward maintaining the financial stability of the REA lending process. This legislation will ensure that the electric and telephone industries will be able to continue to provide the services so necessary to rural America.

STATEMENT OF HON. EDWARD ZORINSKY
A U.S. SENATOR FROM NEBRASKA

REA Investment Pays Dividends

The REA loan programs for these almost 50 years represent a significant federal investment in rural America. The success of the Rural Electrification and Telephone programs in rural Nebraska, as well as in our other states, provides ample evidence that this investment has paid large dividends not only to rural America, but to our cities and towns also.

It has been said that even if the REA program had been a grant program rather than a lending program that the federal investment would have been worthwhile. Not only did the REA program bring rural America into the 20th century in terms of helping ease the tremendous physical burdens that were the lot of our farmers and their families before electricity, but the REA loan programs played a large role in increasing the productivity of the American farmer and our rural communities.

The REA program not only increased the comfort of our rural citizens, but gave them more muscle and leveraged their ability to work. Rural America had a more equal stake in a prosperous America.

"Ripple Effect" Benefits Towns and Cities

And, as importantly, the REA program had an important "ripple effect," providing to be an economic stimulus by making the cash registers on "Main Street" ring. Our merchants and their families benefited and continue to benefit because of the REA program. They, in turn, turned in more and larger orders to the manufacturers in our industrial cities whether they made electric transformers, electric refrigerators, or tractors and combines.

The REA program's benefits flowed not only to rural America, but to our centers of commerce whether they be stores at a country crossroad or a metropolitan center of commerce and industry. And, this is as true today as it was almost 50 years ago.

Need for Capital is a Continuing Need

The goal of the REA program has not been reached. I doubt that it ever will--no more than I believe that Consolidated Edison of New York--after 100 years of service--has completed its work and its need for capital.

We in the Congress recognized this when we included some financing assistance to the investor-owned segment of the utility industry in the form of tax concessions in the Economic Recovery Tax Act of 1981.

Capital Needs as Great as Ever

The need of Nebraska's rural electric (and telephone) systems for capital is as great now after almost 50 years of service as is the need of Consolidated Edison or any other power company.

Rural electric systems also have a continuing need for capital. Capital is needed to "heavy up" or improve facilities to meet new and greater demands for power. And capital is needed to provide service to new customers as they come into rural America.

Rurals: Higher Costs, Lower Revenues

Low-cost capital is especially important to America's rural electric and telephone systems because they are expected--indeed, obligated--to serve the most remote parts of our nation. In Nebraska, for example, the rural electric systems have about 2.1 meters per mile of line whereas the electric utilities which serve our cities may have 60 or more customers per mile of line.

Because more meters per mile of line generally means higher revenue per mile of line and lower operating costs per meter, the fact that Nebraska's rural electric systems provide service at comparable rates gives us reason to take special pride in the rural electric systems which serve our state. The same can be said about the rural electric co-ops that serve in the other states.

Rural Investments Not as Attractive

Because they serve sparsely populated areas as well as the more remote and rugged parts of our nation, the rural electrics would find it difficult to compete in the open market for their capital needs. This problem is compounded by the fact that the rural electrics--even the largest of the rural electric systems--are very small when compared to almost any of the nation's investor-owned electric utilities. The rural electric simply do not represent an attractive investment opportunity for private investors.

The REA loan programs give some assurance to the nation's rural electrics systems that they will at least have access to capital which, otherwise, could well be denied to them simply because they do serve rural America.

S. 1300

Consequently, I am pleased that S. 1300, the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983, has been introduced and that I am included as one of its sponsors.

Not only will it help correct the growing imbalance of the Revolving Fund, but the legislation also will provide the nation's rural electric distribution systems a permanent source of at least a portion of their continuing capital needs. I know that this legislation is the product of a thorough study and lengthy consideration. And, I am pleased that it was introduced in a timely fashion--before the problems it is designed to address reached crisis proportions.

STATEMENT OF HON. ERNEST F. HOLLINGS
A U.S. SENATOR FROM SOUTH CAROLINA

I want to preface my remarks on S. 1300 by thanking you and the other members of the Subcommittee on Agricultural Credit and Rural Electrification for agreeing to hold this hearing. The Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act must be quickly acted upon by the Senate to ensure that our nation's rural consumers will continue to receive dependable and affordable electric and telephone service.

This legislation obviously enjoys broad bipartisan congressional support. On March 1, 1984, the House of Representatives passed its companion bill by a 283 to 111 vote. To date, S. 1300 is currently being cosponsored by forty-two Senators. Because of the wide basis of support for this legislation, I urge my colleagues on this Subcommittee to favorably act on S. 1300 in order to facilitate expedited consideration by the Committee on the whole.

S. 1300 amends the Rural Electrification Act of 1936 to provide for the continued financial solvency of the Rural Electrification and Telephone Revolving Fund (RETRF) and enables rural electric and telephone systems to obtain adequate financing for their operations. By ensuring the financial stability of the RETRF, this legislation will help fulfill our nation's commitment to provide adequate electric power and telephone service at reasonable costs to those Americans living in sparsely populated regions of the United States.

This legislation will insure the financial integrity of the RETRF by:

(1) permitting the REA administrator to raise the interest rates on REA loans in order to insure that interest income balances interest expenses;

(2) allowing the RETRF to retain current treasury notes now in the Fund as permanent capital to alleviate further Treasury borrowing requirements of the RETRF;

(3) permitting the cooperatives to seek additional private funding sources when the distribution demand for loan funds exceeds $1,000,000,000 annually;

(4) directing the Administrator to subordinate or accommodate liens of mortgages if the cooperative has the ability to repay its debt in order to assist the cooperative in attracting private, non-government sources of financing.

Meeting the need for electricity in rural areas is the charge and the responsibility of the 1,000 consumer-owned, not-for-profit rural electric systems. They're doing the job that many phrased "impossible"--and doing it well. Life has changed since the creation of the program and the rural electrics have changed to meet ever-challenging situations. S. 1300 is the answer to the current challenge. Power demand must be met and the people must be served. I urge my colleagues today to support S. 1300. The people of America must be served and S. 1300 is our opportunity, indeed, our obligation to rural Americans.

STATEMENT OF HAROLD V. HUNTER, ADMINISTRATOR
RURAL ELECTRIFICATION ADMINISTRATION

Madam Chairman, and members of the committee, I appreciate this opportunity to appear before you today to discuss S. 1300, a bill to amend the Rural Electrification Act.

I have mixed emotions about testifying today. On the one hand, I cannot help but feel gratified that Congress and the trade associations have heeded the alarms we have sounded over the past several years concerning the deteriorating financial condition of the Rural Electrification and Telephone Revolving Fund (RETRF). When we first started raising those concerns and suggesting types of actions which would help restore the Fund's health, the reaction we received was "if it ain't broke, don't fix it." Our fiscal year 1985 budget proposals have addressed the concerns by gradually increasing supplemental private financing ratios, setting RETRF direct loan interest rates at Treasury's cost of borrowing, and establishing user fees covering salaries and expenses. We believe this is necessary in order to maintain the fund's solvency and achieve the objectives of the 1973 Rural Electrification Act.

Now, rather than solving a potential problem with relatively minor administrative and legislative changes, the same people who once dismissed our concerns are seeking major and very costly legislative changes, including the immediate forgiveness of $7.9 billion worth of debts that do not even begin to come due for another 10 years. For good measure, the proposal asks you to deprive Treasury of uncounted billions of additional dollars in future years through mandating one-way, downward-only refinancing of Certificates of Beneficial Ownership (CBO's) and loan guarantees and requiring that the Secretary of Agriculture request direct appropriations to support discretionary (reduced interest rate) loans. Without these massive additional giveaways, we are told, the long-term viability of the Fund and the REA program is threatened.

Back in 1973, when the RETRF was established, we had a clear expression of Congressional intent and a clear consensus as to the purpose and direction of the RETRF. It was not intended that the Fund require substantial subsidies on a regular basis. The new interest rate of 5 percent was close to the then prevailing cost of money to government. Further, Congress explicitly stated that the borrowers were to be helped toward gradual financial and operational independence from REA.

Unfortunately the proposal before us represents a gross overreaction to the Fund's current problems. It represents an attempt to stampede Congress into actions which purport to strengthen the Fund, but which in fact only serve to delay, at great cost to the taxpayer, the Fund's insolvency. It represents an attempt to perpetuate unrealistically low interest rates, thereby increasing borrower reliance on the Federal government. Thus, this proposal represents a virtually total abandonment of the Congressional consensus we had about the direction and future of the Fund back in 1973.

In 1973, the RETRF was established using $7.9 billion in interest-free loans from the Treasury as seed money. There was never any doubt that these were loans and that they were to be repaid. We are being told that Congress should forgive them now, because their very existence seems to cause anxiety. We are being told that forgiveness of the loans will have no impact on the public debt. Well, if this promissory note signed by one of my predecessors is not a loan, I do not know what it is. If the existence of this loan and others like it cause anxiety, I can prescribe a simple cure: raise RETRF interest rates enough so that the loans can be repaid. The President's fiscal year 1985 budget calls for setting RETRF interest rates at Treasury borrowing rates. This would be sufficient to balance the Fund and would restore the intent of the original Rural Electrification Act. The $7.9 billion is real money, money that cannot be made to disappear by erasing a number in one column and writing it down in another, money that the Fund owes to Treasury, and money that will have to be raised by taxes or Treasury borrowing if the long-term notes are forgiven.

In 1973, the standard RETRF rate was raised to 5 percent. This increase was intended to assure that the $7.9 billion in seed money would grow and would, after the repayment of the $7.9 billion in loans, continue to provide a source of funding for deserving borrowers at reasonable rates. At the same time, the increase to 5 percent brought the RETRF rate more closely into line with the prevailing cost of money to government. Now, ten years later, much of the financial leverage which that $7.9 billion interest free loan provided has been used up. But the leverage has not been exhausted. If, for example, RETRF rates were raised to within a couple of percentage points below the government's cost of borrowing, enough revenues would be generated to permit full repayment of the long-term notes, continuing levels of program activity, and absorption of REA's costs for discretionary (reduced interest rate) loan activity. Such an adjustment in rates would assure that the RETRF would be a source of adequate funding support at clearly favorable but not excessively low interest rates. So what does the proposal before us advocate?

Section 6 establishes a formula which would be used to set RETRF interest rates at levels which will yield sufficient interest receipts to pay CBO interest expenses but will not provide for repayment of long-term notes or even CBO principal. As CBO's mature or are paid through amortization, they will be rolled over through the sale of new CBO's. Consequently, the primary financing vehicle of the RETRF will be annual CBO sales of ever increasing size; in effect, not a true revolving fund.

Of course, for those who are not bothered by increased intrusion of the Federal government into the credit markets, this proposed new RETRF structure is not a problem. But the Section 6 formula dynamics have one additional result: the formula will almost assuredly result in RETRF insolvency. Even with forgiveness of the $7.9 billion, the fund will still go insolvent under program growth and cost of borrowing conditions resembling those of recent years. These conclusions are based on extensive computer modelings of the Fund under the bill's proposals and formula. A description of our methodology and summary of our findings are provided. We would of course be happy to discuss the specifics of our methodology and findings with you, just as we informed the trade associations of our approach and findings back in June. Our analyses demonstrate that the formula fails with equal regularity whether or not CBO's are amortized. Enactment of this bill will put into law a formula which is almost guaranteed to fail.

Speaking of guarantees, the 1973 Act envisioned interest rates on loan guarantees and CBO's which would reflect the rates paid by the Federal government for Treasury borrowings of comparable maturity. Recent high interest rates have resulted in correspondingly high CBO rates, and may result in some high rate loan guarantees. The bill before us provides for penalty-free, one-way, downward-only refinancing of CBO's and loan guarantees. The only types of situations where these provisions do not result in increased cost to government are where the government's cost of borrowing rises to 15 percent and remains there indefinitely. In any case where interest rates follow a downward trend or a more traditional cyclic pattern, the cost to the Treasury of these refinancing provisions will be far greater and more immediate than the forgiveness of the $7.9 billion in long-term notes.

Another major problem with the proposed legislation relates to changes in REA lien accommodation and subordination policies. Those changes could essentially require REA to subordinate its liens for virtually any reason requested by a borrower. We believe that our primary fiduciary responsibility is to assure the security of loans we make. We also believe that we should not allow our security to be diluted by subordinating or accommodating our lien to support ventures not otherwise fundable under the Act. Another major problem is the requirement that REA guarantee third party (National Rural Utilities Cooperative Finance Corporation (CFC)) debt. This provision will only make cooperatives more reliant on Federal government credit guarantees. Further, since states and municipalities are eligible borrowers, the language in Section 7 of S. 1300 could be interpreted to require REA loan guarantees for tax-exempt obligations such as municipal or state bonds. According to the U. S. Treasury, Congress has enacted 24 statutes which preclude Federal guarantees of tax exempts since 1970. Therefore, we strongly oppose this provision.

Quite frankly, we believe that the framers of the bill did not in all cases realize the true extent of the giveaways and forgivenesses contained in those provisions: the costs of those giveaways and forgivenesses to the government, the taxpayers, and future generations of rural electric and telephone consumers/subscribers; and the extent to which this legislation makes the borrowers look like they are seeking an unwarranted and extremely costly handout.

We believe that when one considers the value of many Federal benefits already provided to the cooperatives (e.g., subsidized direct loans, 100 percent loan guarantees, tax-exempt status, tax-exempt municipal bonds for pollution control equipment, incentives under Safe Harbor Leasing even though most cooperatives have been tax-exempt, and preferential access to low-cost Federal power), the proposal before us represents a major increase of about $20 billion that is neither justified nor consistent with the goal of the 1973 Rural Electrification Act calling for greater borrower reliance on private credit. This proposal is in addition to federal subsidies received in the form of the forgiveness of annual interest on the $7.9 billion in the Revolving Fund, and the accessibility of FFB funds at preferential rates. It also is an overreaction to a potential future problem with the Fund. Therefore, we strongly oppose the legislation. If S. 1300 were to reach the President's desk, Secretary Block indicated that he would recommend disapproval.

NRECA Proposed Formula
Section 6 of S. 1300

ABSTRACT

Section 6 of the proposed bill would amend Section 305 (b) of the Rural Electrification Act to include a specific method for determining "standard" interest rates charged to Rural Electrification and Telephone Revolving Fund (RETRF) borrowers. This bill concentrates on increasing interest rates charged to RETRF borrowers, and purports to establish a method or formula which will assure the self-sufficiency of the Fund. Unfortunately, our analyses demonstrate that the method proposed in the bill will not work under program level and cost of money assumptions resembling those of the past several years. Even given all other forgivenesses requested in the bill, the NRECA proposed formula would result in the total depletion of Fund assets in a matter of years. Simply put, the NRECA method proposed in the bill would result in RETRF interest rates which are clearly too low to balance the Fund, rates which in fact are substantially lower than those which NRECA itself determined were necessary in their initial analyses.

This proposed method would also have the effect of changing the entire character of the revolving fund. Despite recent reliance on Certificate of Beneficial Ownership (CBO) sales to support the loan program, the Act amendments of 1973 envisioned an RETRF which would operate under traditional revolving fund concepts: i.e., new loan advances generally balancing loan receipts. The bill's method would institutionalize continued and expanding CBO sales as the primary mechanism for funding loan advances. RETRF rates would be artificially suppressed such that the Fund would be unable to function without CBO sales. We see no rationale for using a method which will make the RETRF dependent on perpetual CBO sales when other methods are available which would assure continued adequate levels of RETRF funding at rates which are below the Government's cost of money.

SUMMARY OF ANALYSES

Using REA's RETRF model we examined how the RETRF would operate given the NRECA proposed formula. This formula is as follows:

> "the standard rate for each account shall be that rate, not less than

> 5 per centum per annum, that would produce, from loans (other than special rate loans) approved from that account during a given period, interest income equal to, but not greater than, the amount of anticipated interest expense on the account's obligations (interim notes, insured notes, and certificates of beneficial ownership) required to be issued or sold during such period to cover loan advances and interest expenses: Provided, that the amount of such obligations to be issued or sold for such purposes shall be determined by deducting the sum of principal and interest receipts and any appropriation under subsection (c) of this section from the sum of loan advances and interest expenses on outstanding obligations of the account during such period."

Reducing this formula to mathematical terms, it would be calculated as follows for each period:

REA Interest Rate =

$$\frac{(\text{Loan Advances} + \text{CBO Interest Expense}) - (\text{Borrowers' Loan Payments})}{\text{Loan Approvals}} \times \text{CBO rate}$$

Example:

Expected 1984 Advances = \$1.1 Billion
Anticipated 1984 CBO interest expense = \$400 Million
Principal and interest payments from borrowers in 1984 = \$910 Million
Loan approvals anticipated for 1984 = \$1.1 Billion
Presumed CBO rate = 11 %

$$\frac{(1.1 + .4) - .91}{1.1} \times .11 = .059 \text{ or } 5.9\%$$

The impact of this proposed formula was analyzed for numerous cases.

Exhibit 1 summarizes the results of our analyses for several of the principal cases we examined.

Note from Exhibit 1 that:

a. The NRECA formula does not produce fund solvency except in cases which appear unrealistic, such as zero program growth and an 8% CBO rate for the indefinite future.

b. Amortization of CBOs does not result in fund solvency under NRECA's formula.

c. REA interest rates remain far below the CBO rate for most cases; such low rates are the cause of Fund insolvency.

d. Under NRECA's proposed formula the RETRF would continue to depend on increasing levels of CBO sales to support the REA loan program.

Exhibits 2 and 3 highlight the fact that the NRECA proposed formula will produce Fund solvency in only a few situations--situations unlike those we've seen in recent years or perhaps are likely to see in the future.

A further problem with the NRECA proposed formula is that it is based on an annualized approach. That is, interest rates for each period are based on expected activity for that period. Thus, if advances or approvals are expected to increase or decline substantially during a given period this could have a profound impact on REA interest rates. The fact that the proposed formula is based on an annualized approach (which could lead to drastic swings in rates) means that it could also be manipulated such that it produces unreasonably high or low rates.

As shown earlier, the NRECA proposed Section 6 formula would not result in Fund solvency however, it is an example of an annualized approach. Thus it is used in the examples below to show the range of REA interest rates that could occur during FY 1984 using an annualized approach.

REA Interest Rate Calculation for Six-Month Period

REA Interest Rates	Advances	CBO Interest	Loan Repayments	Loan Approvals	CBO Interest Rate
6.5 =	((550	+200	-450)	÷ 550)	x 12.0%
7.7 =	((700	+200	-450)	÷ 700)	x 12.0%
3.1 =	((450	+200	-450)	÷ 700)	x 12.0%
9.0 =	((700	+200	-450)	÷ 550)	x 12.0%

Conclusion

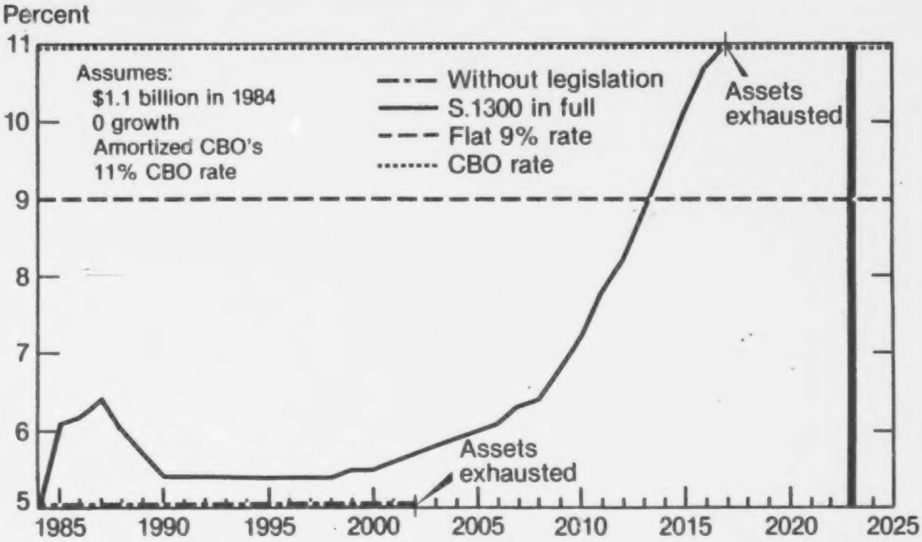
The proposed Section 6 interest rate formula is technically and conceptually flawed in several major ways:

a. It simply does not work, i.e., it does not produce adequate interest rates to result in Fund solvency.

b. It would increase RETRF dependence on funds from Treasury in the form of ever increasing CBO sales.

c. It is based on an annualized approach which can result in drastic swings in REA interest rates from period to period based on the levels of advances and loan approvals and/or the administration of this formula.

"RETRF Interest Rates"



"RETRF Net Notes Receivable"

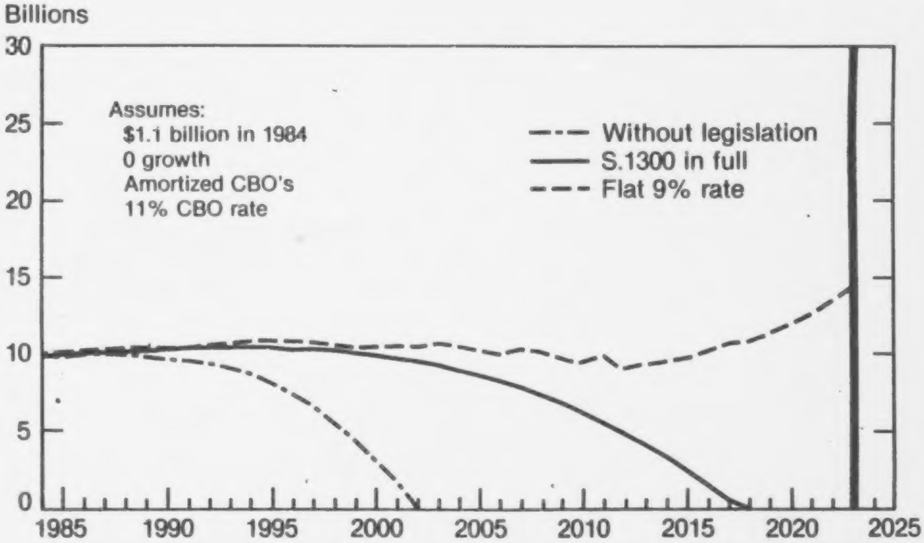


EXHIBIT 1

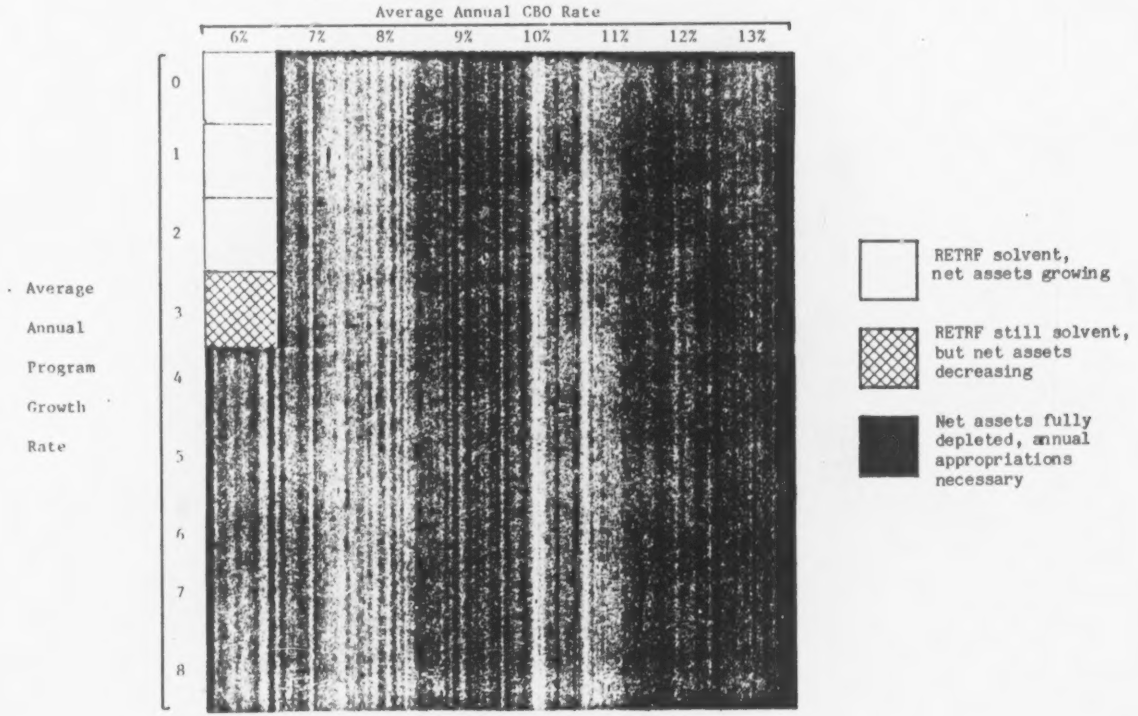
IMPACT OF NRECA PROPOSED FORMULA, SECTION 6, H.R. 3050

NRECA Requested Subsidies					Yr. During Which:		REA LOAN INTEREST RATE						CBO's OUTSTANDING $ in Billions					
Long-Term Note Forgiveness	CBO Refinancing (Downward Only)	CBO Interest Rate	CBO's Amortized	Program Growth*	Interest Expense Exceeds Interest Receipts	Appro- priations Needed	1985	1990	1995	2000	2010	2020	1985	1990	1995	2000	2010	2020
yes	yes	8	yes	0	0.0	0.0	5.00	5.00	5.00	5.00	5.00	5.00	4.0	6.9	8.3	8.6	4.7	- 8.0
yes	yes	8	no	0	0.0	0.0	5.00	5.00	5.00	5.00	5.00	5.00	4.0	6.9	8.3	8.6	4.7	- 7.9
yes	yes	8	yes	6	2001.5	2021.0	5.00	5.00	5.00	5.17	6.29	7.09	4.0	7.6	11.9	18.6	43.4	95.6
yes	yes	8	no	6	2001.5	2021.0	5.00	5.00	5.00	5.17	6.29	7.10	4.0	7.6	11.9	18.6	43.4	95.7
yes	yes	11	yes	0	1993.0	2017.0	6.06	5.45	5.40	5.51	7.25	9.83	4.1	7.6	10.3	13.0	18.9	25.7
yes	yes	11	no	0	1991.5	2016.5	6.23	5.72	5.68	5.77	7.70	9.29	4.1	7.7	10.6	13.4	19.6	25.9
yes	yes	11	yes	6	1992.0	2014.5	6.10	6.84	7.94	8.78	10.04	9.90	4.1	8.3	13.8	22.2	51.7	103.3
yes	yes	11	no	6	1990.5	2014.0	6.27	7.04	8.08	8.87	10.12	9.86	4.1	8.4	14.1	22.5	52.3	103.4
no	no	8	yes	0	1996.5	2011.0	5.00	5.00	5.00	5.00	5.38	5.00	4.1	7.6	10.4	14.2	23.6	25.0
no	no	8	no	0	1995.5	2010.0	5.00	5.00	5.00	5.00	6.51	5.00	4.1	7.6	10.4	14.3	24.6	25.0
no	no	8	yes	6	1992.5	2007.5	5.00	5.00	5.62	6.50	7.12	6.80	4.1	8.4	14.0	23.9	54.9	99.3
no	no	8	no	6	1992.5	2007.0	5.00	5.00	5.67	6.58	7.19	6.78	4.1	8.4	14.1	24.1	54.9	99.5
no	no	11	yes	0	1990.0	2006.0	6.43	5.94	6.32	8.54	9.73	6.86	4.1	7.8	11.2	16.4	25.7	27.1
no	no	11	no	0	1988.0	2005.5	6.61	6.23	6.63	8.87	9.76	6.69	4.2	8.0	11.4	16.8	25.7	27.2
no	no	11	yes	6	1989.5	2005.5	6.47	7.20	8.45	10.00	10.22	9.64	4.1	8.6	14.7	25.5	57.0	104.3
no	no	11	no	6	1987.5	2005.0	6.64	7.41	8.61	10.12	10.23	9.62	4.2	8.7	15.0	25.9	57.1	104.5

* Beginning with a 1984 program of $1.1 Billion ($850 electric and $250 telephone).

EXHIBIT 2

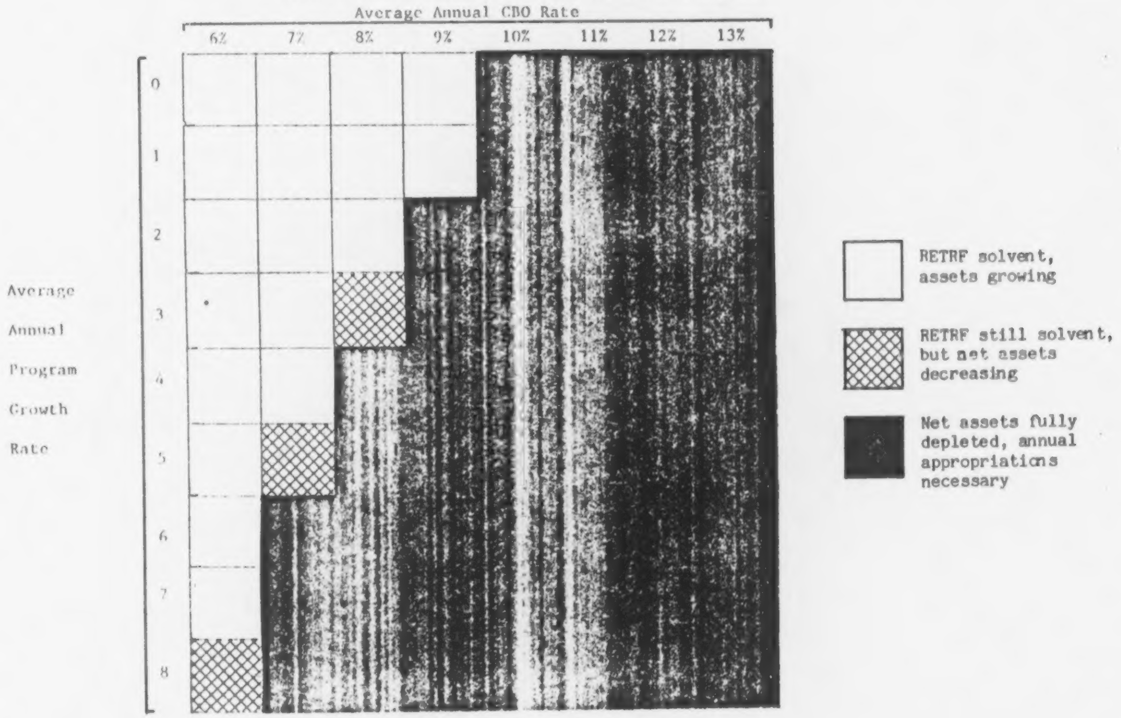
RETRF STATUS IN 2032 USING NRECA-PROPOSED FORMULA



Assumptions: $1.1 Billion program in 1984
Full repayment of long-term notes when due
No refinancing of CBO's

EXHIBIT 3

RETRF STATUS IN 2032 USING NRECA-PROPOSED FORMULA



Average Annual Program Growth Rate	6%	7%	8%	9%	10%	11%	12%	13%
0	□	□	□	□	■	■	■	■
1	□	□	□	□	■	■	■	■
2	□	□	□	■	■	■	■	■
3	□	□	▨	■	■	■	■	■
4	□	□	■	■	■	■	■	■
5	□	▨	■	■	■	■	■	■
6	□	■	■	■	■	■	■	■
7	□	■	■	■	■	■	■	■
8	▨	■	■	■	■	■	■	■

□ RETRF solvent, assets growing

▨ RETRF still solvent, but net assets decreasing

■ Net assets fully depleted, annual appropriations necessary

Assumption: $1.1 Billion program in 1984
Full forgiveness of $7.864 Billion in long-term notes
Downward-only refinancing of CBO's

STATEMENT OF MR. GUY C. LEWIS, JR.

President, National Rural Electric Cooperative Association

Chairman Hawkins, and other distinguished members of the Subcommittee on Agricultural Credit and Rural Electrification. . .

My name is Guy C. Lewis, Jr. I am a resident of Bowling Green, Virginia, where I manage the Rappahanock Electric Cooperative, a consumer-owned and controlled utility system which provides electric service to about 41,000 members in rural Virginia.

In addition to those duties, it is my honor and privilege to serve as President of the National Rural Electric Cooperative Association, the voluntary service organization of the nation's some 1,000 rural electric systems, which deliver electric energy to some 25-million Americans in 46 states.

Madam Chairman, I am most pleased to have the opportunity to present my views on S. 1300, the Rural Electric and Telephone Revolving Fund Self-sufficiency Act.

Because the availability and cost of capital is of such crucial importance to the future of the rural electrification program, it is only natural that, over the years, this subject has been a very major concern to our national association, and to the thousands of rural electric system directors and managers who know that adequate and affordable loan funds are the lifeblood of the rural electrification program.

Rural electric financing has been of special concern to me personally since the fall of 1981, when my immediate predecessor as NRECA President, Mr. Angus Hastings of Florida, asked me to serve as chairman of a special NRECA Committee on Financing for the Future.

This committee consisted of seventeen outstanding leaders, representing every region of the nation and every segment of the rural electric program. It also benefited greatly from the ex officio participation of three former Administrators of the Rural Electrification Administration, Norman Clapp, David Hamil and Robert Feragen, along with the Governor of the National Rural Utilities Cooperative Finance Corporation, Charles Gill.

The committee spent more than a year examining virtually every aspect of rural electric financing, including, of course, a thorough examination of the Rural Electric and Telephone Revolving Fund, the mechanism created by Congress in 1973 to be the source of capital for REA insured loans.

Through a series of open meetings with our members, and consultation with experts from the financial community and elsewhere, we tapped into the best thinking available on every aspect of our financing future.

We knew even before the committee began its work, however, that the combined effect of extremely high interest rates during the past few years, along with continuing heavy demand for REA loans, had put strains on the Revolving Fund far greater than had been anticipated at the time of its creation.

For this reason, we spent a considerable amount of time working, not only to fully explore and define the problems facing the Revolving Fund, but also in seeking ways by which the Fund could be permanently restored to financial strength and stability.

From the very outset of this effort, we strongly felt -- and still believe -- that the REA borrowers themselves, through their national organizations, must take a lead role in creating a workable plan to preserve an adequate and affordable financing program.

This is consistent, I believe, with the reputation the we have worked hard to build as a group ready and willing to assume responsibility for its own destiny -- one that comes to Congress not just with problems, but also with fair and reasonable solutions that make good sense for the rural electrics and for the nation as a whole.

Madam Chairman, it is not my intent to review at this time the full set of recommendations that are the result of the work done by NRECA's Committee on Financing for the Future. To a very great extent, these recommendations are embodied in the legislation before you today, the main provisions of which will be discussed by others scheduled to appear at this hearing.

I think it's important to note, however, that the recommendations of our study committee have been thoroughly evaluated by the full membership of NRECA. The major changes in REA lending policy and practice that would be implemented through enactment of S. 1300 were discussed at length and unanimously endorsed by the delegates to our 41st Annual Meeting in February, 1983.

We have taken great pains to ensure that the NRECA membership is fully aware of all the implications of what is being proposed in S. 1300, including the fact that it will very likely result in an increase in the interest rate charged on REA insured loans.

Our members nonetheless believe that this is the proper course for us to pursue at this time, and that the long-term future interests of the rural electric systems and their member consumers are best served by accepting an increase in the cost of borrowing today.

We firmly believe that this plan is both reasonable and responsible.

It will establish a self-correcting mechanism for REA interest rates that, if implemented in accord with the spirit and intent behind its creation, will ensure that the Revolving Fund will be able to continue for many years in its vital role as a capital source for rural electrification.

It will provide a means by which rural electric borrowers can, at a controlled and orderly pace, continue to evolve toward greater reliance on private lenders to supplement capital borrowed through REA. It will facilitate this movement to the private market by improving the terms under which REA will share its mortgages with other lenders.

It will maintain the present level of federal investment in rural electrification by keeping the assets Congress put into the Revolving Fund in 1973 as part of the Fund for as long as they are needed. Under present law, this initial capitialization of the Fund will be gradually siphoned off, beginning in 1993.

Most important, however, is the fact that the proposals contained in S. 1300 will help ensure the continuing fulfillment of a promise made by our government to the people of rural America nearly 50 years ago: that the comfort, convenience and increased productivity make possible by central station electric service would no longer be reserved only for people in the cities and towns of our nation.

America's independent, consumer-owned rural electric systems have done their part to make the dream of universal, area coverage electric service a reality. And even though we've come a long way, we still face many of the same challenges that existed in 1935, including low consumer density, difficult terrain and high cost of power.

There's no question that we needed the assistance provided by REA to get the rural electrification program started in the thirties and forties. It's just as clear, I believe, that we will continue to need a strong REA for as long as rural electrics operate largely in areas other utilities could not -- or would not -- serve.

Madam Chairman, I truly appreciate this opportunity to appear before this distinguished panel. On behalf of myself, NRECA, and the 25-million men, women and children of our nation who depend on REA financed systems to keep the lights on and the power flowing across rural America, I hope you will give prompt and favorable consideration to S. 1300.

I will be happy to answer any questions you or the other members of the Subcommittee may have to the best of my ability.

# # #

STATEMENT OF MR. ROBERT D. PARTRIDGE
EXECUTIVE VICE PRESIDENT
National Rural Electric Cooperative Association

Madam Chairman and Members of the Subcommittee:

For the record, my name is Robert D. Partridge. I am Executive Vice President and General Manager of the National Rural Electric Cooperative Association, the trade association which represents some 1,000 rural electric systems in 46 states, serving nearly 25-million Americans.

I am most pleased to have the opportunity to address this Subcommittee today, and to express the very strong support of the rural electric program for S. 1300, legislation we believe is vital to the future of both REA financing and the rural electrification program itself.

The amendments to the Rural Electrification Act of 1936, as contained in S. 1300, are critically needed to guarantee the continued stability and solvency of the Rural Electric and Telephone Revolving Fund.

This Revolving Fund was created by Congress in 1973 as the source of capital for rural electric and telephone financing, replacing the practice of using annual appropriations for that purpose which had been terminated the prior year. It is a fund within the Treasury of the United States, administered by the Rural Electrification Administration, and like all other Funds within the Treasury, it is under the direct control of the Congress.

The Revolving Fund has served its purpose well over this past decade. Due to economic conditions which could not have been foreseen at the time of its creation, however -- primarily the inflation of the 1970s and the sky-high interest rates of the period 1979-1982 -- adjustments are now required in its workings.

The keystone of S. 1300 is the provision which gives the REA Administrator new authority to ensure the future financial integrity of the Revolving Fund by allowing him or her to make periodic adjustments in the interest rate applied on REA loans.

For almost all borrowers, this interest rate is now fixed by law at five percent. Although this change in lending terms is certain to mean higher capital costs to REA borrowers and, in turn, higher rates for their consumers, we are satisfied that this is a price worth paying to bring long-term stability to the Fund.

Under S. 1300, the interest rate charged on new REA insured loans will be periodically adjusted to a rate high enough to bring the interest income and interest expenses of the Revolving Fund into balance. We are fully confident that the authorities granted to the REA Administrator in this bill are adequate to achieve this goal and that, if implemented in a reasonable and forthright manner, this approach can halt the current depletion and bring long-term stability to the Fund.

Another very important section of the legislation would convert the funds originally allocated by Congress for REA lending during the period from 1952 to 1972 into an equity capital investment that will remain in the Revolving Fund for as long as Congress deems it necessary and proper for it to be there.

Under present law, REA will be forced to transfer this capital --

amounting to some $7.9-billion in total -- from the Revolving Fund to the Treasury in annual installments beginning in 1993. We strongly contend that the present requirement that these funds be withdrawn from the Revolving Fund will result in no significant benefit to the Treasury, but would add significantly to the cost of providing electric service in rural America.

According to analyses by the Congressional Budget Office and others, the net impact of this provision on the federal budget would be virtually nil, since requiring REA to make these payments would almost certainly force the Revolving Fund to increase its future borrowings from the Treasury by a corresponding amount.

Contrary to the manner in which this provision has been characterized by some of the opponents of the bill, I believe it's perfectly clear that nothing in the proposed legislation would result in the "forgiveness" of any debt. The legislation would not in any way reduce the principal or interest amounts due on any loan made by REA to rural electric borrowers. Not one dime of REA lending would be in any way "forgiven" under this bill.

Further, it's abundantly clear that the Revolving Fund, no less than the Treasury itself, is under the custody and control of the government of the United States. Because these arrangements are always subject to further modification by the Congress, this provision of S. 1300 could be just as accurately portrayed as an open-ended extension of the present "ear-marking" of these assets as capital for the Revolving Fund.

S. 1300 also contains language that would have the effect of ensuring that the supplemental loan ratios and criteria now applied to REA insured loans can be used in a positive and constructive way, as a tool to ensure that available loan funds are fairly distributed among all qualified borrowers.

A further intent of this provision is to prevent the use of these ratios as a means to artificially depress REA lending activity, and in so doing, falsely justify future cutbacks in loan levels. The present requirement that REA loans be supplemented with 30% non-REA funds is already a difficult burden for many cooperatives. The 50-50 ratios frequently suggested by the current Administration would be that much worse.

We believe strong justification exists for giving special consideration to those relatively few systems that operate under extreme hardship, due to the nature of the territories they serve, damage from storms or other natural disasters, or the financial condition of their consumers.

For this reason, we support language in the bill to refine and clarify the intent of the special interest rate loan program. Under this provision, borrowers meeting the appropriate qualifying criteria would be eligible for loans carrying an interest rate of no less than two percent, nor more than one-half the REA rate prevailing at the time of the loan.

There are a number other important provisions in the proposed law which will be discussed by others scheduled to appear at this hearing, including former REA Administrator David Hamil and CFC Governor Chuck Gill. The enactment of these provisions, as you will hear, is critical if the rural electric systems are to continue the steady increase in the use of private, non-REA financing sources that has occurred over the past ten years.

In summary, let me point out that the major provisions of this legislation are the result of two years of hearings and study. It has the unified backing of the nation's rural electric and telephone systems. Three former REA Administrators, spanning 25 years of expertise, have attested to the fact that this bill is responsible, workable and necessary.

We believe this measure is worthy of your support because it will:

-- Make the Rural Electrification and Telephone Revolving Fund the kind of perpetual, self-sustaining source of capital Congress meant for it to be when it was created in 1973;

-- Keep the assets of the Fund where they can continue to be used to meet the on-going needs of the nation's rural electric systems;

-- Increase the income to the government-owned Revolving Fund as a result of the increase in interest rates on REA loans, and,

-- Reduce the need for future Treasury borrowings by expanding the internally generated cash flow of the Fund.

In supporting S. 1300, the members of NRECA are not asking for any new assistance in meeting the still very formidable challenge of providing reliable and affordable electric service to the people of rural America. To the contrary, we are coming to the Congress with a plan by which we will accept higher costs today in order to ensure a reliable and stable source of capital tomorrow.

As its title implies, the Self-Sufficiency Act will keep the lights on in rural America without any additional assistance from the taxpayers in the form of budgetary outlays. It's goal is simply to help the cooperatives help themselves, strengthen their ability to repay their debts, and continue to provide the kind of service that the residents of rural America have every right to expect.

I sincerely believe that the enactment of the bill now before this Subcommittee will be in the best interest of the consumers of rural America and of the citizens of this entire nation.

Thank you. I will be happy to try to answer any questions you may have.

STATEMENT OF MR. DAVID A. HAMIL
Former Administrator, Rural Electrification Administration
U.S. Department of Agriculture

For the record, my name is David A. Hamil. I am a resident of Sterling, Colorado, and have been involved in the rural electrification program for more than forty years. It has been my privilege to serve as Administrator of the Rural Electrification Administration for more years than any other person, having held that position from 1956 to 1961, and again from 1969 to 1978.

Let me say also that I'm delighted to have the chance to appear before this Subcommittee. As some of you may recall, during my service as REA Administrator it was my duty and -- most of the time, at least -- my pleasure -- to report frequently to this Subcommittee on the progress and problems of REA and the rural electrification program.

It was during my second go-around as Administrator -- just about ten years ago, Madam Chairman -- that Congress created the REA insured and guaranteed lending programs we have today.

Up to that time, all government loans for rural electrification had been made under the old direct program, with the vast majority of them made at a two-percent interest rate.

While the amount loan funds Congress was making available at that time for REA direct loans was growing, it was not growing anywhere near as fast as the co-ops' need for financing. Direct loans in the early 1970s had reached nearly a half-billion per year. But even then, we knew we were on the verge of a new era in the rural electrification and telephone program -- one which would have a tremendous impact on the need for new capital.

For one thing, many borrowers were experiencing rapid growth in numbers of new consumers, as the long trend of rural-to-urban migration reversed itself and increasing numbers of Americans moved from the cities to the country.

In addition, the cost of extending lines and building new facilities was rising very fast. This was due to the effects of inflation and to the complex and expensive new requirements placed on all utilities as a result of the great wave of environmental legislation that came into being in the early seventies.

But the most critical challenge by far faced by the co-ops at that time, was the realization that rural electrics would have to move -- and move quickly -- into the business of power generation.

Up to that point, co-ops acquired most of their power by wholesale purchases from investor-owned companies or federally-owned power projects. As we entered the seventies, though, co-ops were getting a very clear message that the power companies would no longer be willing to expand their generating capacity solely to meet the power needs of their wholesale customers. Co-ops also were beginning to see the bottom of the barrel with regard to federal power, at least insofar as meeting future demand growth was concerned.

This left the rural systems with no choice but to work toward increasing their self-reliance in power supply, by building generating and transmission facilities owned and operated by the co-ops, or through facilities jointly-owned with power companies or other utilities.

The problem, back in the late sixties and early seventies, was in the fact that the capital needed for just one medium-sized generating plant would have taken up REA's loan authorization for the whole year. Clearly, the old direct loan program was not designed for, nor could it handle, this next phase in the development of rural electrification.

This is why the REA lending programs created by Congress through Public Law 93-32 -- particularly the loan guarantees -- have been so very important to the continued progress and success of the rural electric program.

Even though they were put together under some very difficult circumstances in the months following the abrupt cut-off of REA lending in December, 1972, today's insured and guaranteed loan programs have made it possible for REA to continue its long-standing and still-vital role as the primary capital source for rural electrification.

All of us are aware, I'm sure, of the many things that have occurred in the past ten years that have had an effect on rural electrics and their financing needs.

The 1973 oil embargo and our resulting national commitment to the goal of energy independence speeded up even further the pace of power plant construction to replace oil- and gas-fired units.

Interest rates hit levels during this period that no one could have predicted ten years ago and inflation, at least until this past year or so, has continued at a very high rate.

Ever-tightening environmental standards on power plant emissions have not only increased the cost of constructing new facilities, but also add to operating costs, since the energy required to run pollution control equipment can take as much as 8-percent of the output of a power plant.

All these things have had their effect on REA lending programs, and in particular, on the financial health of the Rural Electrification and Telephone Revolving Fund which Congress created in 1973 to serve as the capital source for REA insured loans.

In addition, these factors will play a role in the future of the REA financing program, as the growth and revitalization of rural America continue in years to come, and rural electric and telephone systems strive to meet their responsibility of serving their consumers at affordable rates.

As you may know, Madam Chairman, two of my fellow past REA Administrators and I took part in the study of rural electric capital needs completed last year by NRECA's Committee on Financing for the Future. I can tell you from first-hand experience that this committee left no stone unturned in its search for a way to ensure that rural electrics will have access to the capital they must have in the future, at a cost rural electric consumers can afford to pay.

I personally am satisfied that the recommendations which this study committee developed, and which are contained in large measure in S. 1300, are both reasonable and fair -- to the REA borrowers, and to the nation as a whole.

If implemented in a positive and forthright manner by the person sitting in my old chair at REA, I believe this legislation can bring about the kind of self-perpetuating financing system that Congress had envisioned when the Revolving Fund was created ten years ago. Further, my 14 years of experience at REA gives me full confidence that the career staff at REA is capable of administering the program in the way Congress intends it to be run.

The proposed changes in the RE Act also will help iron out a few kinks in the lending process, and, in the long run, help make the borrowers financially more able to look to lenders other than REA for their future capital needs.

It's worth noting, I think, that the rural electrics have made great progress during these past ten years in increasing their use of non-REA, private capital sources. At present, only a small fraction of the new capital investment in rural electrification is in the form of REA loans at interest rates of five percent or less. For most of the past decade, the majority of the new loan funds have been either in the form of REA guarantees -- which are at the full cost of money to the government -- or as supplemental loans made by CFC and other private lenders at open-market rates.

The legislation before the subcommittee today would not by any means stop this process of "weaning" the rural electric borrowers from what not that long ago was a total dependence on REA. To the contrary, it gradually and on a reasonable basis narrows the gap between the REA standard rate and market interest costs. It also leaves the door open for future adjustments in the supplemental loan requirements, allowing the Administrator to move the financially-strongest systems toward financial independence even faster.

I should point out, if I may, that the idea of moving the program toward increasing reliance on non-governmental financing sources is not something new to the 1980s. As Administrator, I started laying the groundwork for this kind of transition as early as 1958. By the time we got to the mid-sixties the borrowers themselves were beginning to think in these terms, and in 1969, they created the National Rural Utilities Finance Corporation -- CFC -- as their own source of non-governmental financing.

When I first started going to NRECA's national meetings, there wasn't a banker in the crowd. Now, you see representatives from CFC, the Banks for Cooperatives and as many as 150 other banking institutions ready and willing to work with rural electric and telephone systems. The provisions contained in S. 1300 on accommodation and subordination of REA's security interest in its borrowers will be a critical factor in making it possible for these private lenders to do business with the rural electric and telephone systems.

If we do, in fact, want to move the program out from under the government umbrella, I believe we've got to be willing to give the borrowers some slack in this way. The idea is definitely not to give away government assets, but rather to help bring outside money into the program -- an idea which I would have thought the Administration would be supporting lock, stock and barrel.

I can't overemphasize, however, that reducing the role of REA is not something you can do overnight. Just as Rome wasn't built in a day, neither was the rural electrification program. It's going to take time -- and that, to me, is the most important thing that S. 1300 does; it gives the REA lending program and its borrowers the additional time needed to grow, to become financially stronger and to move toward other sources of capital in a gradual and orderly way.

Madam Chairman, with your indulgence, I'd like to make just a few general comments on the question of the "subsidy" that rural electric and telephone systems derive from their access to REA financing, and the controversy that has arisen on the provision in S. 1300 to convert some $7.9-billion of notes REA owes to the Treasury into permanent capital for the Revolving Fund.

There has been quite a bit of debate over this question of subsidy; mostly about the exact number of dollars involved, and who gets more: the co-ops, the municipals or the power companies. Because this debate, however, I think everyone has come to understand the fact that every single consumer of electric power in this nation is being subsidized, one way or another, by the federal government.

Personally, I think that's fine. Electric power has become such a basic necessity of life that there's nothing wrong with government taking steps to ensure that all Americans can get what they need at a reasonable price.

Whether or not the amount of subsidy being received by each type of utilities -- investor-owned, municipal, and rural electric -- is exactly equal is, in my opinion, not really that important.

Reasonable comparability of rates should be the determining factor, and if the rural electrics need a little extra help to achieve that goal, I think its a worthwhile investment of our government's resources to give them that help.

This is particularly true in light of the tremendous benefits the nation as a whole receives from the improvements rural electrification has made possible in agriculture -- preserving our abundance here at home, while helping maintain our trade balance abroad. Every American farmer now produces enough food and fiber to feed himself and 78 other people -- and that number keeps growing every year.

This relates directly, of course, to the issue of the $7.9-billion conversion provision of the bill which some of those who oppose it have termed "forgiveness," or a "bail-out."

Here again, I've never been inclined to argue bookkeeping with the bookkeepers. But when you boil everything down, there are two facts that remain unchallenged.

First, that no existing or future REA borrower will be released of its responsibility to repay every penny of the money lent to it -- including all of the interest agreed to in the terms of the note.

And second, that all of the funds used for rural electrification -- whether they are in the Revolving Fund, the Treasury, or anywhere else -- will always be owned and controlled by the people of the United States, through their elected representatives in Congress.

Should the time come that the need for REA financing cease to exist and the Revolving Fund is liquidated, all of these funds would revert to the Treasury. It's simply a matter of the Fund being allowed to continue its use of these funds for as long as they are needed -- instead of having to give them back at the end of an arbitrary 40 year period.

Some have attacked this aspect of the proposal on the ground that it may have the effect of reducing Treasury revenues in 1993 and beyond. Some opponents have, I'm told, made the contention that this bill could cost the nation's taxpayers something like $20-billion. I've spent no little time looking at this bill from every angle, Madam Chairman, and I'm here to tell you that it just isn't true. In fact, if you let me factor in the tremendous benefits that the REA program provides for the nation, I suspect I could pick up a pencil and make the case that S. 1300 could create a $20-billion benefit to the nation.

But even if there are some costs involved, rural electrification always has been -- and will continue to be, in my opinion -- among the best investments government has ever made.

Finally, I think it's worth noting that it has been the REA borrowers themselves who have come forward with this proposal to remedy the problems of the revolving fund, even though this will result in an immediate increase in their financing costs. Some people have been taking pot shots at this proposal, but if someone else has a better plan, I'd very much like to see them come forward with it.

Madam Chairman, let me once again say how good it is to be back again before this distinguished panel, and how much I appreciate this chance to express my support for S. 1300.

Thank you.

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STATEMENT OF CHARLES B. GILL, GOVERNOR

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

Senator Hawkins, and members of the Committee, my name is Charles B. Gill. I am the Chief Executive Officer of the National Rural Utilities Cooperative Finance Corporation, which is generally referred to as CFC. I appreciate the opportunity to discuss the amendments to the Rural Electrification Act proposed in S. 1300.

CFC is a cooperative financing organization owned by 935 members, including 807 rural electric distribution systems, 60 power supply systems, 66 state, regional and national service organizations and 2 associate members.

CFC was incorporated in April 1969 for the purpose of providing its members with a source of long-term and short-term financing to supplement their borrowings from the Rural Electrification Administration. The first long-term loans made by CFC concurrently with loans from REA were made in 1971. Prior to then, rural electric systems obtained all of their debt capital under the REA loan program.

During the 1960s, it became apparent that funds made available by the Government would no longer be sufficient to satisfy the capital requirements of the rural electric systems for expansion and improvement of their distribution, generation and transmission facilities. CFC was established by the rural electric systems to meet this capital deficiency. The recommendation to create CFC was a part of the final report of the Long-Range Study Committee appointed in November 1967 by the National Rural Electric Cooperative Association (NRECA). That report included not only the recommendation for the establishment of CFC as a self-help supplemental financing source but also a statement of present and future objectives for the rural electric program.

With the establishment of CFC, the REA Administrator adopted a new policy which required applicants for loans to obtain a portion of their capital requirements "from a financial institution other than REA." He also promulgated criteria for determining eligibility for such concurrent loans and provided for their periodic review and adjustment.

Our first long-term loans were made concurrently with REA loans in February 1971. Since that time, CFC has approved over 3,800 long-term loans to distribution and power supply systems concurrently with REA loans. We have also made more than 100 long-term 100% loans to CFC members. As of February 29, 1984, approximately $1.85-billion in long-term CFC loans were outstanding and $607-million in long-term commitments were unadvanced.

In the last three years, CFC has approved, on average, about 250 long-term loans concurrently with REA loans. The majority of CFC's loans are for 30% of the capital required and have totaled approximately $250- to 300-million each year.

The availability of long-term financing continues to be of vital importance to the rural electric program. Under present criteria, REA is providing approximately 72% of all of the long-term loans made annually to distribution systems. The REA loans are funded from the Rural Electrification and Telephone Revolving Fund and the amendments proposed in S. 1300 to authorize the REA Administrator to adjust interest rates on new loans should assure that the fund will continue to function as a viable financing source for REA loans.

CFC interest rates are reviewed at each meeting of the Board of Directors and adjusted to reflect cost of long-term CFC funds. Our long-term interest rates have been as low as 7% and were as high as 14%. They currently are 11¼%.

CFC obtains funds to make advances on its loan commitments from several sources. These include proceeds from the sale of collateral trust bonds, the Capital Term Certificate "equity" investments made by CFC members, and patronage capital.

To date, CFC has marketed approximately $1-billion of collateral trust bonds in 13 bond issues which have maturities ranging from 7 to 35 years at interest rates from 7.4% to 15.75%. In the 11 years that CFC has been selling bonds in the market, they have received increasing acceptance by the investment community and are presently rated by major rating agencies as AA (Standard & Poor's) and AA3 (Moody's).

In addition to long-term loans, CFC provides short-term and intermediate-term loans. These programs play a most important role in enabling our members to make the most efficient use of their financial resources, while carrying out their utility responsibilities within their service areas.

Short-term loans (lines of credit) provide members with commitments for periods of up to twelve months. Through this program, CFC members are assured of a readily available source of funds to meet current cash flow needs. Currently, CFC has about $515-million outstanding in short-term loans.

Intermediate-term loans are made for periods of up to five years. These loans are utilized primarily by power supply systems for "front-end" financing required in the planning, design and early construction phases of bulk power supply projects until such time as long-term funding becomes available. The proceeds of intermediate-term loans are used to finance such requirements as engineering, environmental and feasibility studies, site acquisitions, fuel procurement, progress payments on equipment purchases, initial funding of construction, and funding requirements of power supply systems for joint participation with investor-owned utilities in bulk power supply projects. CFC has approximately $273-million outstanding in intermediate-term loans. In the recent past, the amount outstanding of such intermediate-term loans has been as high as $450-million.

In addition to its direct loan programs, CFC also provides for guarantees of long-term and short-term tax-exempt industrial development revenue bonds which are sold to finance the construction or acquisition of pollution control facilities installed in a member's power generating plant or to finance the acquisition of headquarters or service buildings. The credit support added by the CFC guarantee makes the tax-exempt funds available at the lowest possible interest cost. The major rating bureaus have recently upgraded the ratings on CFC guaranteed bonds and they presently are rated A1 by Moody's and AA- by Standard and Poor's. CFC has provided such guarantees for about $1.4-billion of long-term and interim-term bonds and tax-exempt commercial paper notes.

CFC has also provided approximately $600-million in credit support to enable its members to participate in lease transactions.

From 1973 to 1983, loan commitments from all lending sources to rural electric power supply and distribution systems total about $46.5-billion. Of this amount, about $4.5-billion have been supplied by non-governmental lenders.

Nearly all the loan commitments by private lenders have been made concurrently with loan and guarantee commitments from REA. This is in accordance with the statement of Congressional policy in the 1973 amendments to the RE Act, that "...rural electric and telephone systems should be encouraged and assisted to develop their resources and ability to achieve the financial strength needed to enable them to satisfy their credit needs from their own financial organizations and other sources at reasonable rates and terms consistent with the loan applicant's ability to pay and achievement of the Act's objectives."

From the beginning of the supplemental loan program in 1971, CFC loans to its members were secured pari passu with the REA loans. CFC has a shared first mortgage position in proportion to the amount of its loan to the total borrowing of its member.

Section 306 of the 1973 RE Act amendments authorized the REA Administrator to guarantee loans and to accommodate and subordinate the liens of mortgages held by the REA Administrator. In its report on this legislation (H. Rept. 93-91, page 10), the House Committee stated:

> "The Administrator is also expressly empowered to accommodate and subordinate mortgages in the fund, whether the mortgages are held by the government as owner or as trustee or custodian for investors who have purchased the notes secured by such mortgages. While established legal principles support the Administrator's existing power to waive or modify the government's security rights, explicit statutory authority in the bill to accommodate and subordinate government mortgages is intended to emphasize the discretionary authority of the Administrator to so accommodate and subordinate where it would effectuate the purposes of the legislation.
>
> "These authorities to guarantee, accommodate and subordinate are expected to be exercised by the Administrator for the purpose of facilitating and supporting the ability of systems to borrow from non-REA lenders at reasonable and competitive rates and terms where their borrowing needs are beyond the resources made available for REA loans under the bill."

CFC members, particularly power supply sytems, have found it necessary to borrow substantial amounts of money to carry on engineering, environmental and economic studies to proceed with plans for generating facilities. In many instances they were required to make substantial investments to assure adequate fuel supply and acceptable sites for the generating stations. Under REA policy and procedures, long-term funding is not available until the Administrator, among other things, makes a finding as to the feasibility and necessity of a power project. Therefore, the power supply systems found it necessary to borrow large amounts of money, prior to receiving final REA loan approval, for as long as two to three years. To obtain the funds for these developmental activities, the power supply systems turned to CFC for "front-end" financing. CFC made these intermediate-term loans subject to REA's approval of a lien accommodation to provide CFC security. In May, 1976, REA prepared "Notes on Front-end Financing of Power Supply Facilities" to be used by the REA staff in processing recommendations for the Administrator's consideration and action in connection with requests from CFC for lien accommodations to secure its loans.

The guidelines contained in the REA "Notes" require a finding be made that the system borrowing funds from a private lender will have adequate security to cover its obligations in the event the project is aborted. In analyzing the financial condition of a borrower, REA does not focus on the economic feasibility of the system's continued operation, but does place great weight on whether sufficient assets would be available for REA to obtain full payment of its outstanding debt if foreclosure should be necessary. REA staff have been instructed to measure the net worth ("nuts and bolts" figure) by calculating the present value of the physical assets through application of the Handy Whitman index to determine the current depreciated replacement value of the physical assets.

REA has stated that, in the absence of precedents to indicate the value of revenue flows assured by the 40 year all-requirements power contracts that distribution systems have with their power supply system, the more tangible elements of security should be calculated and totaled before undertaking a determination of the value to be ascribed to member contracts.

It should be noted that the granting of lien accommodations permits a lender to have the benefit of mortgage security for its loan. This includes not only a security interest in the physical assets of the borrower but also is applicable to any additional property acquired by the system and rights to the revenue flows arising from the operations of the system. In negotiations with REA concerning specific requests for lien accommodation to provide security for CFC loans, we have found that REA has consistently adopted a rigid position focusing exclusively on the need to make findings that "adequate physical security" is available and that there is a "compensating benefit" for the government.

As a result of this restricted interpretation with regard to granting of lien accommodations, CFC's ability to implement programs which would reduce costs to its members has been blocked. The REA requirement for each transaction to demonstrate that granting a lien accommodation would result in a "compensating benefit" to the government has prevented rural electric systems, with the assistance of CFC, from putting into effect business arrangements which would result in a reduction of costs of operation. This in turn would have benefited the rural electric consumer in the form of lower power rates. An example of one such instance involved a power supply system which was operating a strip mine to provide coal for its power plant. The system is required by law to meet state land reclamation standards. To assure that the power supply system carries out these responsibilities, the state agency requires posting of a bond in an amount which would be sufficient to reclaim the land in accordance with state standards. CFC developed a guarantee program which would have been at a minimal cost to the system to provide the assurance to the state that the power supply system would have access to the funds. The CFC program was structured to provide that as a condition of such guarantee, it would receive a lien accommodation on the property of the system to take affect only if CFC were called upon to provide financing under the guarantee. REA refused to approve this guarantee arrangement and the granting of lien accommodations. As a result, the power supply system has been required to pay large annual fees to bonding companies to meet the requirements of the state reclamation agencies.

In our judgment, the efforts of the rural electric systems to follow the Congressional policy of encouraging borrowing from non-REA lenders at reasonable, competitive rates and terms is being frustrated.

The rural electric systems began their operations completely dependent upon securing all of their financing through the REA loan program. Accordingly, under the terms of the mortgage with the Government, all of the assets that they own or which they might acquire in the future are pledged to the Federal Government. The most feasible way of introducing non-Government capital into this program is through use of lien accommodations and the establishment of reasonable guidelines for granting such lien accommodations. We strongly believe that it would be most advantageous for both the rural electric systems and the Federal Government if the Administrator would conduct the REA programs consistent with the 1973 statement of Congressional policy.

In November, 1981, the CFC Board, in recognition of the value and importance of periodically re-examining the role of CFC in the rural electric program, authorized establishment of a Committee on Objectives and Planning. The Committee was charged with the responsibility of reassessing CFC's goals and objectives with the purpose that the membership could have assurance its organization had the ability to meet their supplemental financing and financial services needs, both now and in the future. The Committee was also requested to examine CFC's structure and operations to determine whether it was providing services to its members in an efficient manner.

The Board selected twenty-five leaders of the rural electric program representing distribution and power supply cooperatives and national and state service organizations from all areas of the country. The Committee held numerous meetings; undertook studies on future capital requirements of the distribution and power supply systems through the end of this century. They consulted with experts in the investment community about the most efficient ways and means of raising the capital required and reviewed rural electric program objectives in providing electricity in their service areas and undertaking activities and providing leadership in projects to improve the quality of life in rural areas. During 1982, the Committee worked very closely with the NRECA Committee on Financing for the Future, holding several joint meetings around the country with rural electric leaders and sharing data and information.

The CFC Committee presented its report to the CFC membership which endorsed all of the recommendations.

One important recommendation made by the Committee calls for amendment of the Rural Electrification Act "to clarify the authority of the REA Aministrator to provide private lenders with marketable security for loans they make to REA borrowers". Section 7 of S. 1300 proposes to amend Section 306 of the Rural Electrification Act to implement that recommendation and would resolve many of the problems that CFC has encountered in recent years in negotiating with REA to obtain adequate security for the loans that CFC makes to its members.

The provisions of S. 1300 which would amend Section 306 of the RE Act would make it clear that the REA Administrator can grant a lien accommodation on a finding of economic feasibility of the operation of a borrower's system. This could be assurance that the system would receive adequate revenue through the sale of power and the borrower has, or will have, the ability to repay all indebtedness of the system. To reinforce this provision, we urge the Committee to include in its report on this legislation a specific directive that it would expect the REA Administrator and staff to carry out the intent of this amendment so that other lenders will be able to provide financing at reasonable rates and terms.

We believe that the directive which the Congress urged the Administrator to follow, as described in the statement of legislative intent in the 1973 amendments to the Rural Electrification Act, has not been carried out. Therefore, we believe it is necessary for this directive to be expressed in legislation, which is the purpose of the amendment to Section 306 of the Rural Electrification Act contained in S. 1300. The thrust of this amendment is consistent with the rationale which has been followed for many years to support debt financing for municipal utilities. Bonds issued by municipal utilities are supported entirely by the revenues produced from their operations. The investment community has recognized that economic feasibility is a valid test in determining the quality of the bonds and rate them accordingly. We believe the directive proposed in this amendment would insure the creation of a sound public and private partnership for the rural electrification program.

STATEMENT OF DAVID C. FULLARTON, ON BEHALF OF THE NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

Introduction

Madam Chairwoman and Members of the Subcommittee. My name is David C. Fullarton. I am the Executive Vice President of the National Telephone Cooperative Association (NTCA). NTCA is a national trade association made up of 450 locally owned and operated small telephone systems providing service to five million consumers in the the most rural areas of 42 states, Puerto Rico and Guam.

I appreciate the opportunity to appear before you today to discuss the need for changes in the Rural Electrification Administration (REA) loan programs. Our long-standing support of the REA telephone program spans three decades. When our association was formed in 1954, the telephone loan program was still in its infancy. We have grown together and relied upon one another and have changed, accordingly, as times have changed.

That is what is at the heart of this legislation: the ability of REA to change as times warrant. NTCA supports S. 1300 in the strongest possible terms. The basis for that support comes from our members' years of experience in delivering high caliber telephone service to rural Americans. Allow me to provide a framework of reasons why NTCA believes the time has come to pass S. 1300. I will define the problems we have experienced, and outline solutions incorporated into the legislation. Let me say at the outset that this legislation parallels the recommendations of some of the finest minds in rural telephony: our members of the NTCA Future Financing Committee, who spent many weeks researching and exploring alternatives in reaching solutions to these problems with the help of Joseph Vellone of who is seated beside me today.

Mr. Vellone is NTCA's Special Counsel. He joined our staff in 1982 with the primary responsibility of helping our members explore the potential sources of financing for their diversified operations and to prepare for industry changes brought on by competition and deregulation. He came to NTCA directly from REA where he had been serving as Acting Assistant Administrator for Administration and Assistant Secretary of the Rural Telephone Bank. In these positions, he directed and coordinated the general administrative activities of six separate divisions within REA. Mr. Vellone also provided technical assistance to the House Committee on Agriculture in drafting the legislation which eventually created the telephone revolving fund in 1973. I cannot imagine an individual better qualified to address your comments, as he will following my statement.

As many of you are aware, the REA telephone loan program was created by Congress in 1949, when fully 62 percent of rural areas were without telephones. What little service there was, was provided on inadequate multi-party lines. The telephone loan program came into being because it was not feasible to serve most underpopulated areas, where capital costs are higher and customers are sparse, at interest rates required by most lenders. Today, though 95 percent (REA figures) of rural Americans have access to telephone service, it is still not feasible for the small telephone systems serving high cost rural areas to provide that service at commercial interest rates.

But the REA program stepped in to fill a vital need. It offered rural telephone companies low interest loans in exchange for a commitment from each borrower to extend service to the largest practical number of subscribers, regardless of profitability. Recognizing the need for technical assistance, REA also established standards specifically for the design of rural telephone systems; equipment specifications, engineering designs and construction techniques. Within ten years, REA assistance had extended service to subscribers in 45 states through 700 telephone companies.

The success of the program was borne out by the fact that by 1971 the need for growth capital had far surpassed the availability of funds in the telephone loan program. As a result, REA changed with the times. The Rural Telephone Bank (RTB) was created by Congress as a means of providing supplemental financing at higher, closer-to-market interest rates. The establishment of the RTB served two important functions: it allowed companies which could feasibly pay the higher interest rate to provide their customers with better quality service, while it relieved some of the pressure on the lower interest REA insured loan program.

Another important change came in 1973, when Congress established the Rural Electrification and Telephone Revolving Fund as the new source for REA loans. This followed on the heels of Administration impoundment of funds that had already been appropriated by Congress. Initial assets of the fund included outstanding notes of REA borrowers and undisbursed balances of previously approved REA loans. Its liabilities included $7.4 billion in non-interest bearing REA notes to the Treasury. The revolving fund is replenished through collections on outstanding and future REA loans, interim Treasury borrowings, and money from the sale of Certificates of Beneficial Ownership (CBOs), which represent pools of borrower notes that REA holds on its loans.

The REA telephone loan program has been an unqualified success. Not one loan has been lost through foreclosure. The program has been instrumental in developing and maintaining the nation's universal telephone network. It has made modern, affordable telephone service possible for upwards of 11 million rural Americans. In no small measure, the success of the program has rested on its ability to adapt in changing times.

Today is one of those times.

The Problem

REA telephone program borrowers still face high capital costs distributed among fewer customers than do urban systems. But today this problem is just one among many confounding rural telephone companies, and the picture is critical.

The telecommunications industry is in the midst of a tremendous upheaval. The long-standing national commitment to universal telephone service is precarious, at best, due to sweeping changes in the way the industry is regulated. While recent Federal Communications Commission (FCC) and court decisions would allow telephone companies to provide services and equipment on a deregulated basis, these same decisions would cause the erosion of traditional sources of small company revenue, such as payments to the local system for long distance services. The access charge scheme promulgated by the FCC would add yet another burden to residents of rural areas; a burden which, down the road, will contribute to spiralling rural rates. At present, there is great uncertainty as to the future of rural telephone rates. New proceedings in the FCC's Access Charge Docket are scheduled for later this year. And almost weekly, related FCC decisions are announced which could threaten the viability of small, rural telephone systems.

The continued viability of telephone service for rural people will be a critical element in maintaining the national network. Pockets of rural America still remain without telephone service. Moreover, there is still a great disparity in the quality of telephone service. Approximately 20% of rural subscribers have access to party-line service only. Now is the time to face the challenge: to equip REA to help rural telephone systems better grapple with these problems.

To survive in the competitive environment mandated by the FCC, rural telephone companies must develop financial strength through diversification with new services and operations that will provide new sources of revenue to support the necessarily high costs of local rural service.

Two roadblocks stand in our way. First, most small, rural telephone systems still cannot qualify for financing on the commercial market, with their low equity ratios. The average net worth of all REA telephone borrowers at the end of 1982 was only 26.3 percent of total assets. Clearly, most small, rural telephone systems will require continued government financing to supply high-cost local telephone service for the foreseeable future.

Secondly, current REA policies deny borrowers access to other sources for financing which is not available under programs administered by REA. The agency holds a first lien on all property owned or subsequently acquired by the borrower, regardless of whether the funds to purchase the property were provided by REA or another lender. In addition, REA has generally refused to share its lien with private lenders willing to fund projects which REA is not now financing, unless the borrower agrees to provide a "compensating benefit" to the government. REA often narrowly defines that term to mean reducing the term of existing REA notes, or in some cases, prepaying one or more of the notes. In most cases, this is simply not practical.

Since most private lenders require a first mortgage position on new projects or a favorable common mortgage covering existing and new plant, current REA policy makes it difficult -- if not impossible -- for borrowers to secure financing for worthy projects that could strengthen their overall financial stability and actually enhance the government's loan security.

In addition, REA's policy on the use of general funds often works to prevent borrowers from investing their own funds in new plant that could help ensure long-term viability in the face of increasing competition within the local exchange area. The current general funds policy requires a telephone system to maintain its general funds (REA considers money spent in prior years directly or indirectly for "miscellaneous physical property" as still available to reduce the amount of the next loans or loan advance) at a level below eight percent of its total telephone plant investment, if the borrower wants to continue receiving new loans or advances on existing loans.

REA recently took steps to defuse this issue by proposing to allow borrowers who can pay dividends or retire capital credits without prior REA approval to invest the amount of the allowable distribution instead in new telecommunications projects, without having it count in the general funds calculation. However, any service not classified as telephone service under the existing definition would have to be provided through a separate subsidiary.

This proposal would offer little relief. Few borrowers can make distributions without REA approval in an amount large enough to provide a subsidiary with an equity base that would attract private capital. In fact, some telephone cooperatives could encounter legal restrictions or adverse tax effects by investing in a subsidiary. Again, the problem is exacerbated by the fact the REA steadfastly refuses to share its mortgage security with other lenders.

NTCA has raised these issues time and again with the administration, but to no avail.

Along with administration policies that preclude commercial lending to rural telephone systems, there is increasing strain on the ability of the revolving fund to meet the capital requirements of rural telephone companies. Inflation and high interest costs have combined to take a toll on the fund over the past decade. Borrower repayments meet only part of the demand for new loan funds and interest payments on the fund's obligations, primarily CBOs with interest rates between 10 and 15 percent. The disparity between the rates REA must pay for funds and the five percent rate it receives on loans to telephone systems has created a growing imbalance in the revolving fund. By 1986, the fund's interest costs are expected to exceed its interest receipts from borrowers.

The Solutions

These problems are serious, but not insurmountable. NTCA has been working with other associations to draw up recommendations for solving these problems; to provide a framework to help REA once again change with the times. Many of the recommendations are found in S. 1330. This legislation would ensure the continued financial health of the REA telephone program in two major ways. First, it would authorize the REA administrator to adjust the standard interest rates on new REA loans periodically to the level required to ensure that the revolving fund's interest expenses are recouped. (At the same time a discretionary loan program would provide loans to systems experiencing financial hardship at a rate somewhere between two percent and half the standard rate.)

Second, the legislation would exchange $7.9 billion in notes payable by REA between 1993 and 2016 for an equity interest in the revolving fund. Contrary to contentions on the part of the administration, there is no "forgiveness" of debt involved. In effect, the government would be providing equity capital instead of debt capital to strengthen the revolving fund. This is the same procedure used by many corporations in issuing stock for convertible bonds. Without this provision, the revolving fund would have to borrow even more to remain viable, largely offsetting any advantage to the Treasury from retiring the notes. In addition, the change would involve no government appropriations. Without it, interest subsidies of more than $30 billion--almost four times the amount of the notes involved--would be required between 1993 and 2016. The first of such subsidies, authorized under current law, is included in the 1984 appropriations bill, approved by both the House and the Senate.

The proposed legislation contains several provisions that would help borrowers diversify their operations and secure private market financing. The most important of these would direct the REA Administrator to subordinate or accommodate its liens at the request of the borrower, reflecting a positive step in adapting to a changing telecommunications environment. As new supplemental sources of financing have developed, an unfortunate conflict has arisen between the administration's desire to reduce borrowers' reliance on REA and its simultaneous refusal to share its security interests in borrower assets with other lenders. The provision would require lien accommodation, upon a finding that the borrower can repay its debt, for any purpose that would enhance financial strength or revenue. This expanded authority would encourage other lenders to provide loan funds that are not available through REA or the Rural Telephone Bank.

The Administration has suggested restoring the balance in the revolving fund by cutting the amount of available loan funds and raising interest rates, forcing borrowers to come up, somehow, with supplemental financing on the commercial market. The Catch-22 is transparent: without the lien accommodations and other administrative policy adjustments detailed in S. 1300, borrowers would be unable to secure private market financing.

I would like to point out that this legislation should be viewed as a comprehensive, forward-thinking package. The rural electric and telephone borrowers ought to be commended for their foresight; for taking the courageous step that will cost them the immediate price of raised interest rates, in exchange for putting into place the basis for a healthy, viable revolving fund to which they can turn for funding in the long term.

It is ironic that an administration that is dedicated to reducing the dependence of REA borrowers on government financing would oppose policy changes that would accomplish just that. NTCA members share the desire to free themselves from government-imposed financial restraints so that they may assume their rightful place in the telecommunications revolution. That is why NTCA has endeavored to focus congressional attention on the problems and find attainable solutions before the situation deteriorates to the point at which a massive congressional bail-out is required to preserve telephone service in rural America.

It is time once again, for REA to change with the times.

STATEMENT OF JOSEPH VELLONE, ON BEHALF OF THE NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

The National Telephone Cooperative Association (NTCA) and its member systems throughout Rural America are grateful for this opportunity to present statements on legislation required to (a) eliminate the need for appropriations to cover interest subsidies on loans made from REA's revolving fund at the statutory maximum interest rate, and (b) make the Rural Electrification Act more responsive to the needs of Rural America. These objectives are complementary and it would be difficult to achieve one without the other.

NTCA Executive Vice President David C. Fullarton has presented, in his remarks and in his prepared statement, the need for such legislation in a changing environment. I will discuss the various sections of S. 1300, the "Rural Electrification and Telephone Self Sufficiency Act of 1983," and give some of the reasons why proposed amendments merit your support.

A. REA Telephone Loan Provisions

Sec. 2. Eliminating Nonduplication Finding for REA Telephone Loans

Sec. 2 of H.R. 3050 amends sec. 201 of the Rural Electrification Act by striking from the next to the last sentence the requirement that no telephone loan shall be made in any state with a State regulatory body having authority to regulate telephone service and to require the loan applicant to obtain a certificate of convenience and necessity unless such certificate is first obtained. The requirement in the present Act is superfluous as sec. 202 provides that "Nothing contained in this Act shall be construed to deprive any State commission, board, or other agency of jurisdiction, under any State law, now or hereafter effective, to regulate telephone service which is not subject to regulation by the Federal Communications Commission, under the Communications Act of 1934, including the rates for such service."

Sec. 2 also strikes the last sentence in sec. 201. This is necessary to eliminate the present requirement that no loan shall be made in a state which has no regulatory body authorized to issue certificates to the applicant unless the Administrator determines that no duplication of lines, facilities, or systems, providing reasonably adequate services will result therefrom.

Since 1949, when this provision was added to the Act, the Administrator has been required to make a nonduplication finding before making a loan only in states where the regulatory body did not require the applicant to obtain a certificate authorizing the proposed construction. A certificate, however, is not necessarily a guarantee of "nonduplication," and in today's competitive environment, nonexclusive certificates should become very common.

The present law makes it difficult for REA to finance competitive facilities in a state where there is no state regulatory body with certificate jurisdiction over the borrower. This could result in small telephone systems being denied financing for an interconnection with more than one long-distance carrier, if the nonduplication finding requirement is not eliminated. Elimination of the requirement would help borrowers in states or territories which do not require REA borrowers to obtain certificates, such as:

California
Guam
Maine
Maryland
Massachusetts
Montana
Nebraska
New Hampshire
New Jersey
North Carolina (Co-ops)
Ohio
Oregon
Puerto Rico
Vermont
Washington

Sec. 3. Revising Definition of Telephone Service and Rural Areas for Telephone Loan Purposes

Sec. 3 amends sec. 203(a) to clarify the definition of telephone service. This is desirable to reflect changes in technology. Transmission of data, which is a growing operation of all telephone systems, is specifically mentioned, as well as transmission by wire, fiber, radio, light, or other visual or electromagnetic means. Message telephone service, community antenna television service not intended exclusively for educational purposes, and radio broadcasting, however, continue to be excluded from the definition.

Sec. 3 also amends sec. 203(b) to modify the definition of rural area to include towns with populations of 2,500 or less. The limit of 1,500 was established in 1949. The change is considered necessary to facilitate transfers of territory to improve the operating efficiency and even the viability and loan security of the systems involved in the new deregulated competitive arena.

B. REA Electric and Telephone Loan Provisions

Sec. 4(1). Increasing Revolving Fund's Equity Capital

Sec. 4(1) amends sec. 302 to provide that the notes of the Administrator to the Secretary of the Treasury to obtain funds for loans under sections 4, 5 and 201 of this Act "shall be equity capital of the fund" instead of "liabilities of the fund."

This amendment will strengthen the revolving fund by exchanging REA's notes to the Treasury for equity interests in the fund, thus reducing the need for new borrowings or sales of certificates of beneficial ownership to keep the fund viable. To understand the operations of the revolving fund, it is necessary to review the fund's origin and the model on which it was based.

On December 29, 1972, the Department of Agriculture announced in a two page press release the termination of REA's direct loan programs and the impoundment of $456 million of unobligated funds appropriated by the Congress. The press release stated that "Beginning on Jan. 1, 1973, all REA loans will be made as guaranteed and insured loans under the authority of Section 104 of the Rural Development Act of 1972 (Section 306(a)(1) of the Consolidated Farm and Home Development Act)."

To resolve the conflict between the executive and legislative branches, Congress proceeded to develop amendments to the Rural Electrification Act providing for a "Rural Electrification and Telephone Revolving Fund" patterned after the "Rural Development Insurance Fund" but without the restrictions in the Rural Development Act which Congress considered to be inappropriate for rural electric and telephone systems.

These amendments became law on May 11, 1973. To establish REA's revolving fund, the 1973 amendments transferred to it all of the following assets:

Outstanding notes payable by electric and telephone borrowers to REA	$6,598,683,958
Undisbursed balances of electric and telephone loans	882,132,617
All collections of principal and interest from borrowers after June 30, 1972	261,964,343
Other assets, including "all appropriations for interest subsidies and losses which may hereafter be made by the Congress"	60,000,000
Total assets	$7,802,780,918

The law made the revolving fund liable for $7,408,638,673 of notes issued by REA to the U.S. Treasury from August 14, 1953, through March 19, 1973, for amounts borrowed to make advances on 2 percent loans to borrowers. With assets of $7.8 billion and liabilities of $7.4 billion, REA's revolving fund was started with a net worth or equity investment by the Government of $0.4 billion or only 5 percent of its assets.

The 1973 amendments authorized use of the fund's assets for payment of these notes (without interest) on their original maturity dates (ranging from June 30, 1993, through December 31, 2012). The 1973 amendments also authorized and *directed* the Secretary of the Treasury to purchase any new notes issued by the revolving fund to "discharge obligations of the fund."

In 1974 and 1976, REA issued two additional notes which are also liabilities of the fund. They cover amounts used to settle the *Sioux Valley* case (504 F. 2d 168) and amounts previously impounded. Long term notes payable by REA to the Treasury total $7,864,742,067.68, attributable to the electric and telephone programs as follows:

Electric	$6,028,195,224.03	76.6 percent	76.65
Telephone	1,836,546,843.65	23.4 percent	23.35
Total	$7,864,742,067.68	100.0 percent	

All collections of principal and interest on loans made to REA borrowers become assets of the fund and are used to make advances to borrowers and pay interest on the fund's obligations. These collections, supplemented by undisbursed balances of notes to the Treasury, were sufficient to cover advances to borrowers through fiscal year 1975. Starting in fiscal year 1976, however, certificates of beneficial ownership (CBOs) were issued to the Federal Financing Bank at interest costs ranging from 8.1 percent to 15.3 percent to meet cash needs of the fund in excess of collections on outstanding loans. CBOs issued through September 30, 1983, totaling $3,467,507,000, carry an average interest rate of 11.394 percent.

A CBO evidences the sale of some of the borrower's notes in the revolving fund's inventory of notes under a trust agreement whereby the revolving fund promises (a) to pay interest to the purchaser of the CBO at a stipulated rate greater than the interest rate specified in the borrower's notes to REA, and (b) to repurchase the CBO at its maturity date. This is not an unusual arrangement. Farmer's Home and other agencies do this and obtain an appropriation every year to cover the difference between interest received and interest paid. Although the 1973 law authorized Congress to make appropriations for interest subsidies and losses to keep the revolving fund viable, the 1984 appropriation bill, approved by both the House and Senate, is the first one containing appropriations for these purposes.

House Report No. 98-231 (98th Congress, 1st Session), June 3, 1983 on the "Agriculture, Rural Development, and Related Agencies Appropriations Bill, 1984") states, at page 73:

REIMBURSEMENT FOR LOSSES

1983 appropriation	....
1984 budget estimate	....
Recommended in the bill	$197,862,000
Comparison:	
1983 appropriation	+197,862,000
1984 budget estimate	+197,862,000

This appropriation is to reimburse the Rural Electrification and Telephone Revolving Fund for the differential between interest income and interest costs. The amount recommended by the Committee represents interest costs less the imputed interest associated with loans transferred into the fund when it was established on May 11, 1973.

The Committee feels that the Rural Electrification and Telephone Revolving Fund should be treated the same as the other revolving funds of USDA. Unlike the other revolving funds, there has never been an appropriation to this Fund. In fiscal year 1984, the appropriation for interest and other losses of the other funds are as follows:

Rural Housing Insurance Fund	$1,508,082,000
Agricultural Credit Insurance Fund	895,522,000
Rural Development Insurance Fund	477,829,000
Rural Communication Development Fund	375,000

Rather than allow the Fund to continue to deplete its assets, the Committee recommends an appropriation of $197,862,000 to restore the Fund to a sound financial basis. This appropriation is budget authority only and has no impact on outlays.

The purpose of this little history is to make it clear that if no action is taken to amend the law at this time to balance the revolving find by authorizing periodic adjustments of interest rates, as recommended by NTCA and others, the amount of appropriations needed for interest subsidies authorized by the present law will greatly exceed the amount of non-interest bearing notes proposed to be exchanged for equity interests in the fund. Under present law, these notes are scheduled to become payable by REA's revolving fund starting nine years from now and continuing through the year 2016. Charts prepared by REA (See Exhibit 1) indicate that appropriations for such subsidies are expected to total some $30 billion dollars in the 1993-2016 period -- almost four times the amount of REA notes payable to the Treasury, without interest, in the same period.

In supporting H.R. 3050, members of NTCA and other associations understand that the bill, if enacted, will make the present standard interest rate for loans from the revolving fund a floor instead of a ceiling in order to cover the interest expenses on the fund's obligations. They will be paying these interest rates (which can easily be four times the interest rates they were paying at the end of 1972 and 33 percent higher than the rate they were paying at the end of 1982) for almost a decade before the first of REA's non-interest bearing notes to the Treasury becomes due in 1993. Cash to pay these notes as they mature will be available only if (a) appropriations are made to cover interest subsidies and losses to prevent depletion of the fund's assets as set forth in House Report No. 98-231, and (b) borrowings or sales of CBOs are increased to "discharge obligations of the fund" as set forth in the 1973 amendments. These are methods authorized under the present law. These methods would have the effect of offsetting any reduction in the size of the national debt that the Administration anticipates would result from the payment of the notes as originally scheduled.

If the funds to retire these notes are obtained from borrowings or sales of CBOs, the interest costs of these additional CBOs would be reflected immediately in increased interest rates on new loans. Because the amount of notes maturing each year from 1993 through 2016 varies considerably, the interest rate required on new loans would fluctuate greatly from year to year. It is reasonable, therefore, for borrowers to expect, in return for accepting immediate increases in interest rates on their new loans, some protection from the drastic increases that could be required to refinance notes not reaching maturity until at least 9, and as many as 32, years from now.

Exchanging these non-interest bearing notes for an increased proprietorship or equity interest in the fund, similar to the exchange of convertible bonds for stocks in corporate enterprises, will strengthen the revolving fund. It will benefit the REA borrowers and the rural people they serve without adding to the national debt. In fact, enactment of this legislative package will save the Treasury billions of dollars by making unnecessary appropriations to cover interest subsidies on loans made at the standard rate -- appropriations authorized under present law and routinely approved each year for other revolving funds. As House Report No. 98-231 points out, four other USDA revolving funds received appropriations for interest subsidies and losses totaling almost $3 billion in fiscal year 1984.

Sec. 4(2). Requiring Payments on CBOs

Sec. 4(2) amends clause (2) of sec. 302(b) to conform it with the proposed amendment to sec. 302(a) making the REA notes equity instead of debt capital, and to specifically provide for the payment of principal and interest on the CBOs.

Believe it or not, sec. 302(b) states the the "assets of the fund shall be available only for the following purposes" and the repayment of principal and interest on CBOs is not included in the purposes listed!

Sec. 4(3). Providing Separate Electric and Telephone Accounts in the Fund

Sec. 4(3) adds a new subsection (c) to sec. 302 to provide for two separate accounts within the fund, one for the electric and one for the telephone program. Each account will include the assets, liabilities, income and expenses pertaining to the particular program.

In the recent past, the Administration recommended a zero loan level for the telephone program. Realizing that collections from the telephone program would be used to make advances on electric loans compounded the unhappiness of the telephone systems. Although there have been no losses in the telephone program and only minimal losses in the electric program (many years ago), problems in both programs could result in some losses in the future. This amendment would assure that collections from each program would be used only in that program and not diverted to provide loans or cover losses in the other.

Sec. 5. Authorizing Repurchase of CBOs Without Penalty

Sec. 5 adds a new sentence at the end of sec. 304(c) authorizing the Administrator to repurchase outstanding CBOs without penalty when their interest rate exceeds the current rate on new CBOs by one full percentage point or more.

CBOs have been issued so far only to the Federal Financing Bank. Although that agency has been borrowing short term to obtain the cash for these long term obligations, its formula for determing the amount needed to prepay a CBO generally results in a penalty which discourages any such prepayments.

The ability to make these prepayments could result in substantial savings in interest costs for the revolving fund and the rural people served by its borrowers.

Since CBOs may be issued to purchasers other than the Federal Financing Bank in the future, this proposed amendment might affect the marketability of CBOs in such cases. It is therefore recommended that the amendment be further amended by inserting, after the words "under this subsection" the following words "by another entity in the Federal Government."

Sec. 6(1). Authorizing Adjustments of Interest Rates

Sec. 6(1) amends sec. 305(b) to direct the Administrator to set and periodically adjust the standard rate of interest for new loans made from the electric account and the standard rate of interest for new loans made from the telephone account, in the revolving fund, to make each of them sufficient to cover the interest expenses of the respective account; and to authorize special rate loans for borrowers that meet specified criteria and are experiencing financial hardship.

As set forth in the discussion of the advantages to the Treasury in enacting sec. 4(1), adjusting the standard interest rate from time to time on loans from the revolving fund will result in saving billions of dollars for the Treasury as it will make unnecessary appropriations, presently authorized, for interest subsidies on standard rate loans. Rural electric and telephone systems are willing to pay the higher interest rates needed to keep the interest income and expenses of their respective revolving fund accounts in balance if they can obtain, in the same legislative package, other improvements in the programs administered by REA.

Sec. 6(2). Removing Requirement for Expediting Sales of Insured Notes

Sec. 6(2) redesignates subsection 305(c) as subsection 305(d) and eliminates the requirement that revolving fund "loans shall be sold and insured by the Administrator without undue delay."

The present requirement is difficult to administer for construction programs that require advances of loan funds as construction progresses over periods as long as five years. Loans, or certificates of beneficial ownership therein, should be sold only as needed to meet the fund's cash requirements. Hasty sales could provide the fund with cash at times when it is not needed. This would add to the spread between the fund's interest income and expenses as the fund has to pay market, or higher, rates of interest to the holders of insured notes or certificates.

Sec. 6(3). Requiring Budget Request to Replenish Fund for Cost of Special Rate Loans

Sec. 6(3) inserts a new subsection 305(c) requiring the Secretary of Agriculture to request appropriations to cover the costs of special rate loans.

This subsection has been criticized by the Administration "as a step backward" in the financing of REA programs. This criticism is unfounded as it overlooks that fact that the present law authorizes "appropriations for interest subsidies and losses" on all revolving fund loans -- not just the special rate loans. The number of special rate loans under the proposed criteria is not expected to be much higher than the number of special rate loans under the present law.

Secs. 7(1) and (2). Expanding Lien Accommodation Authority

Secs. 7(1) and (2) amend sec. 306 by redesignating it as subsection 306(a) and specifically requiring the Administrator to accommodate and subordinate liens or mortgages at the request of the borrower to enable it to obtain credit from other lenders for any purpose that would improve the "efficiency, effectiveness, or financial stability of the borrower, upon a finding that the borrower has, or will have, the ability to repay its existing and proposed indebtedness." The amendments would include "refinancing" specifically as a purpose for guaranteeing loans and make "any lender approved by the Administrator" eligible for loan guarantee.

REA has adopted questionable policies curtailing the use of REA and Telephone Bank funds for purposes which have traditionally been financed by loans from such sources. Borrowers wishing to borrow funds for these purposes from another lender find that getting REA to share its mortgage lien on satisfactory terms with another lender is a real problem and involves extended delays. REA has an "after acquired clause" in its mortgage which states that REA's lien extends to all of the borrower's property owned or subsequently acquired by the borrower even if the funds for the property were not provided by REA or the Telephone Bank. This clause is being used by REA as leverage to impose conditions on borrowers and lenders which discourage both from entering in such financing arrangements.

If the purpose to be financed by the other lender is a purpose which REA claims it cannot itself finance under the Rural Electrification Act, the problem intensifies. In such cases, REA generally demands a "compensating benefit" for sharing its lien with the other lender. Frequently, this is interpreted as requiring reducing the term of existing REA notes or prepaying one or more notes, conditions which make unattractive activities which would strengthen a borrower's overall financial stability and actually enhance the government's loan security.

In the past, REA has been more liberal than it is today in providing lien accommodations without exacting a "compensating benefit" for purposes which it itself could not finance. Sec. 7(2) of the bill would require lien accommodations "for any purpose that would enhance the financial strength or revenue or improve the efficiency, effectiveness, or financial stability of the borrower, upon a finding that the borrower has, or will have, the ability to repay its existing and proposed indebtedness." Obtaining financing that meets these standards should, in itself, be considered as a satisfactory compensating benefit for REA's action and the determination that the borrower will have the ability to repay all its indebtedness should be considered adequate security protecting the Government's interest. It should be noted that revenue bonds, secured solely by a system's proposed revenues, is the predominant method used for securing loans to many utilities, particularly those owned by Government entities.

The report on the bill should stress the need for REA to recognize that other lenders must receive lien accommodations on mutually satisfactory terms if REA borrowers are to be "encouraged and assisted to satisfy their credit needs" from "other sources at reasonable rates and terms," as set forth in sec. 1 of Public Law 93-32, May 11, 1973.

Sec. 7(3). Making Any Approved Lender Eligible for Guarantees

Sec. 7(3) amends sec. 306 to include in the definition of a "guaranteed loan" one made or refinanced by "any lender approved by the Administrator."

This would permit guaranteeing loans made or refinanced by lenders that are not organized primarily as "lending agencies," such as other electric and telephone utilities, manufacturers, or suppliers. Similar language appears in sec. 7(2) of the bill so that liens may be accommodated or subordinated for any "lender approved by the Administrator."

Sec. 7(4). Promulgating Rules and Authorizing Lenders to Adjust Interest Rates

Sec. 7(4) adds a new subsection 306(b) to require the Administrator to promulgate rules for the guarantee of loans and the accommodation and subordination of liens or mortgages, and a new subsection 306(c) to authorize the lender of a guaranteed loan advance to adjust the interest rate on the advance, without penalty, if the interest rate exceeds the current rate on new advances by at least one full percentage point.

The new subsection 306(b) would give your committee and its counterpart in the House an opportunity to review the proposed rules before they go into effect. The new subsection 306(c) is similar to the new provision proposed for subsection 304(c). The principal lender under the REA guarantees is the Federal Financing Bank which has no provision for adjusting interest rates on its loans to REA borrowers, with or without penalty. The Director of the Office of Management and Budget has reported that the Treasury and FFB have been borrowing short term to obtain cash for long term lending. FFB could therefore easily afford to make such adjustments when interest rates fall and reduce the interest burden on rural people served by borrowers with guaranteed loans.

C. REA Electric Loan Provision

Sec. 8. Maintaining 1983 Supplemental Loan Ratios for Electric Program

Sec. 8 amends sec. 307 to provide that 1983 criteria and ratios for supplemental financing in the electric program will be maintained in any fiscal year when the minimum loan level is established by law at less than one billion dollars.

This is considered necessary because of the frequent attempts by the current Administration to reduce the loan levels and increase the supplemental financing required. Increasing supplemental financing effectively increases the composite interest rate electric borrowers must pay. As this legislation will also increase interest costs for the same borrowers, further increases through increased supplemental financing would unduly burden the consumers served by the nation's rural electric systems.

D. Rural Telephone Bank Provisions

Sec. 9.- Rural Telephone Bank Capitalization

Sec. 9 amends sec. 406(a) by striking "but not later than fiscal year 1991" from the second sentence. This is considered necessary to assure that authority for the Government's purchase of Class A stock in the Rural Telephone Bank is not terminated until the full amount authorized has been purchased. Present law limits each annual purchase through fiscal year 1991 to no more than $30 million. Without this change, a smaller purchase in any year would have the effect of permanently reducing the total amount of stock authorized to be issued by the Bank, thus depriving the Bank of capital needed to qualify more borrowers for Bank loans instead of the lower interest rate revolving fund loans.

Sec. 10(1) amends sec. 408(a) to eliminate the proviso that loans made by the Rural Telephone Bank for acquisition of telephone lines, facilities, or systems to improve the efficiency, effectiveness, or financing stability of borrowers require approval of the Secretary, and any exchange facilities for local services to be acquired shall not be greater in size than the borrower's existing system when it received its first bank loan. The borrower's first bank loan could have been made more than a decade ago when it was considerably smaller than it is today.

The current proviso is undesirable and should be eliminated because:

1. It can effectively prevent consolidation of territories to realize operating economies in today's competitive environment.

2. No limitations on size of acquisitions apply to the lower interest rate loans available from the revolving fund.

Sec. 10(2). Interest Coverage Requirement for Telephone Bank Loans

Sec. 10(2) amends par. (4) of subsection 408(b) to make the interest coverage ratio required for Telephone Bank loan eligibility more flexible and to have the ratio computed on a pre-tax instead of a post-tax basis.

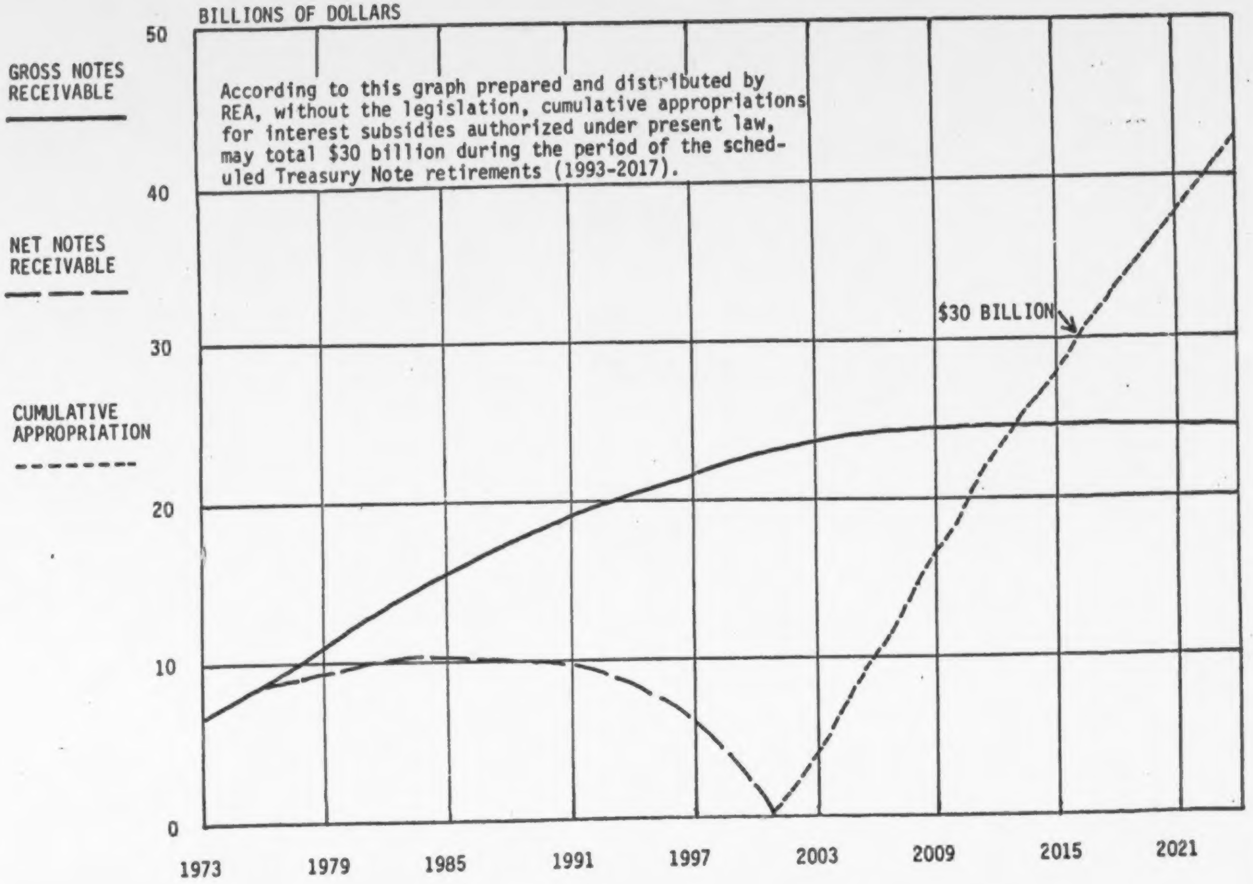
Currently, to qualify for a Telephone Bank loan, a borrower must be able to produce net income before interest at least equal to 150 percent of the interest requirements on all existing and proposed loans, or such higher percent as may be fixed from time to time by the Telephone Bank Board in order to allocate available funds equitably among borrowers. By computing the interest coverage ratio before interest and income taxes, the proposed amendment would conform the calculation to accepted financial and industry practices and give to the Telephone Bank Board the flexibility needed to reduce as well as increase the ratio in order to make optimum use of funds available at any time from the REA and the Telephone Bank. When, for example, the Telephone Bank has ample loan funds available and REA has a shortage of loan funds for the telephone program, the Bank's board could lower the interest coverage ratio required for Bank loans and thus qualify more borrowers for Bank loans.

Sec. 10(3). Elimination of Nonduplication Finding for Bank Loans

Sec. 10(3) eliminates par. (5) of subsection 408(c) and its requirement for a nonduplication finding on Telephone Bank loans in those states where borrowers are not required to obtain a certificate of convenience and necessity. This is the same change as the one proposed for REA loans in sec. 2 of the bill. As set forth in the explanation of that section, this would not preempt the comprehensive state jurisdiction outlined in sec. 202 of the present law. It would, however, facilitate financing for interconnections with more than one long distance carrier by eliminating the presently required nonduplication finding in some 15 states and territories.

EXHIBIT 1

NOTES RECEIVABLE & CUMULATIVE APPROPRIATION



According to this graph prepared and distributed by REA, without the legislation, cumulative appropriations for interest subsidies authorized under present law, may total $30 billion during the period of the scheduled Treasury Note retirements (1993-2017).

STATEMENT OF
A. HAROLD PETERSON
on behalf of
THE NATIONAL REA TELEPHONE ASSOCIATION

Madam Chairman and members of the Committee:

My name is A. Harold Peterson. I am the Executive Director and Counsel of the National REA Telephone Association. This association is comprised of the privately-owned telephone companies who borrow their capital needs from the Rural Electrification Administration. Accompanying me today is John F. O'Neal of Washington, D.C., who is the association's Associate Counsel. We appreciate the invitation and opportunity to appear before your committee to support S.1300, the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983.

REVIEW OF REA TELEPHONE PROGRAM HISTORY

The telephone amendment of the REA act was signed into law on October 28, 1949, thirty-four years ago. During the ensuing years there have been major changes to the REA act. The last major change occurred in 1973. Today, there remain only two United States Senators and six Congressmen who were in the Congress when this legislation was originally adopted. Only thirty-three Senators and 129 Congressmen in the present Congress were members ten years ago. It seems appropriate, therefore, that we review some of the history of the REA program to sharpen your focus and perspective as you begin consideration of the changes suggested in S.1300. While both the electric and telephone programs are involved, we will limit our historic review to the telephone segment only.

In 1949 there were scattered throughout our country over

5,000 telephone companies most of whose facilities were built during the period from 1900 to 1920. For the most part, these facilities comprised the old magneto and common battery systems with open wire outside plant. In many instances, a single pair of wires served as many as 25 customers. Our own telephone company in Chisago City, Minnesota where I live had just such a system until rebuilding commenced in 1955 under the REA telephone program. These old systems were forty to fifty years old in 1949 and were badly in need of rebuilding. The problem was that no bank, insurance company or any other lender was willing to lend the money that was necessary to rebuild and extend these telephone systems. Simply put, the financial vacuum existed throughout rural America wherein there was little or no hope of attracting the necessary debt capital to modernize these systems. It was in this time of helplessness in which these telephone companies found themselves that the Congress of the United States looked at the tremendous achievement that was being accomplished in bringing electricity to rural America and decided that the same kind of program could be utilized to bring modern telephone service to rural America. Thereupon, the Congress acted and passed the telephone amendment to the REA act which was signed into law on October 28, 1949. The statement of Congressional policy indicated: "...that adequate telephone service be made generally available in rural areas through the improvement and expansion of existing telephone facilities and the construction and operation of such additional facilities as are required to assure the availability of adequate telephone service to the widest practicable number of rural users of such service." The first loan was made in 1950 to the Florala Telephone Company in Alabama. In the early years the REA standard of service in rural areas required that there be no more than eight customers on one line. The critics of the program in those days railed that this was gold plating, irresponsible, economically unsound and that the companies would be unable to repay the loans. How wrong the critics of those early days were will be covered later in our statement when we explain the accomplishments of the program.

As the telephone program developed, the capital needs in both the electric and telephone segments increased. As the early sixties approached, there was not only pressure to eliminate the 2% interest rate at which the loans were being made, but there was pressure to look for supplemental sources of financing for both the electric and telephone programs. After repeated attempts failed to establish a bank for both the electric and telephone borrowers in the sixties due to the strident opposition of the investor-owned electric utilities, the electric borrowers embarked in a different direction and established what is now known as CFC. We continued the battle on the telephone side to set up a rural telephone bank within the Department of Agriculture. This was finally accomplished in 1971 after a six year struggle. The Rural Telephone Bank was signed into law in May of 1971. It was patterned after the Farm Credit System which had proved to be so successful over the past 50 years. The RTB is an instrumentality of the United States Government; it has a 13 member board of directors, three of whom are elected by the cooperative-type entities who borrow, and three of whom are elected from the private entities. The REA Administrator is by law Governor of the bank. Provision is made for eventual conversion to private ownership, as was the case in the Farm Credit System, which today is a totally private banking institution. Since 1971 the RTB has been a very valuable source of supplemental financing for those companies who have matured enough financially to be able to pay a higher rate of interest. The present bank lending rate is now 10%. It has been as high as 12.25%. In the early years it was 8%. From its inception to date, the Rural Telephone Bank has made over $1.5 billion in loans.

In 1973 major changes in the REA act occurred, one of which was the creation of the "Rural Electrification and Telephone Revolving Fund". In addition, there were changes in the interest rate. A "standard rate" of interest of 5% was established to replace the previous 2% rate for most borrowers. The rate of 2% was retained for those borrowers who met a specified criteria. In addition, the Administrator was authorized to make 2% loans in hardship cases. The 1973 Act also provided for the Administrator to guarantee loans made by other lenders. To date the Federal Financing Bank, an arm of the U.S. Treasury, has been the primary lender of the guaranteed loans. The "special rate" loan program was eliminated in a 1981 amendment to the Act so that loans are now made at a 5% rate of interest from the Revolving Fund except for hardship cases where the Administrator is still empowered to make a loan at a lesser rate than 5%. Over the 34 year history of the telephone program, as the borrower's financial ability and maturity of the borrowers increased, the interest rate paid by the borrowers has increased: from the original 2% rate which existed until 1971 to a standard rate of 5%, to a Rural Telephone Bank which has ranged between 6.5% to 12.25%, and finally, a guaranteed loan rate which equals the government's cost of money in the private market.

PROGRAM ACCOMPLISHMENTS

The REA program, both electric and telephone, has brought untold economic and social benefits to rural America during these 34 years. Consider the following facts: In 1949 only

38% of the nation's farms had a telephone compared to 95% at the end of 1982. In 1950 the program served 29,000 customers from 17 companies. Today over 4.5 million customers are served by 1,028 REA telephone companies which comprise 72% of the nation's 1,432 independent telephone companies. In 1958 only 4% of REA customers had one party service, compared to 82.5% at the end of 1982. Where feasible, new digital switching equipment is replacing the old electro-mechanical type in the central offices. Buried cable is replacing open wire, outside plant in order to escape the costly ravages of turbulent weather.

It can truly be said that the REA telephone program has brought modern telephone service to Rural America equal to that rendered in urban areas. Our member companies are very proud of this accomplishment. We are also proud of the fact that there has never been a default on a loan in the entire 34 year history of the REA telephone program, in which over $6.5 billion has been loaned. We know of no other Federal program that can come close to matching the record of REA, both electric and telephone. It is a tribute to those electric and telephone entities who accomplished this record, but in a larger sense, it is a tribute to the Congress of the United States, who in its wisdom, saw the need and met it with a legislative policy that made all of this possible. This Committee has played the major role over the years in making this record possible. For this, our association is extremely grateful. Our companies will continue to do their utmost to continue this fine record. In spite of all that has been accomplished, the job is not yet over. There are countless homes in the United States still without a telephone. Last year alone, over 170,000 REA telephone subscribers were added to the rolls. REA added 14 new borrower companies last year. We hope that this history of our program which we have recited will enable those members of Congress who are not acquainted with our record to have a clearer understanding of the program and its current needs.

CURRENT TELECOMMUNICATIONS ENVIRONMENT AND EFFECT ON REA PROGRAM, BORROWERS AND CUSTOMERS

One needs only to reflect on what the media has told us during the past year to know that a gigantic transformation is taking place in the telephone industry today. The court-ordered divestiture of the Bell System and Federal Communication Commission orders, which will take the industry from a regulated monopoly to a competitive environment, has every telephone company in the United States wondering what the end result will be. The industry which has brought our nation the finest telephone system in the world at reasonable rates is undergoing vast change. Last year 64% of the total operating revenues of all REA telephone companies were derived from the long distances revenues generated throughout the nation. We are told that this is a subsidy that cannot continue in a competitive environment. We are told by the FCC that this cost must be shifted to the end user of the service as the cost-causer, namely the residential and small business customer. Without attempting to provide a detailed analysis on what is happening in the Courts, the FCC and in other Committees of Congress, we do want to cite several of our concerns. First of all, the "competition" which is being so widely discussed will not benefit rural America. It will benefit the long distance carriers who have targeted about 135 American cities whose population exceeds 100,000 people. This is where the "big bucks" are generated for long distance calls. These are the high-density, low-cost areas of our country. REA telephone companies serve the low-density, high cost areas of our country. People are being told that rates will more than double in the urban areas of our nation. We are concerned, and we know you are too, about how high they will go in rural America. The Commerce Committees of both houses of Congress have been addressing this issue for the past seven years. They have been told by economists that service has to be driven to cost in a competitive environment. They have been told by economists that if something is not done to correct the present method of toll settlement procedures in the country that many large businesses will by-pass the local telephone company and build their own systems. All of this is being done in the name of encouraging new technologies. Many people, including members of Congress, are vitally concerned about future rates because the Chairman of the FCC himself has testified that he does not know what effect the order will have on telephone rates.

This is a far too brief picture to describe what is happening in such a technical and complicated industry. We do want the Committee to know that the Rural Telephone Coalition has been working hard for the past four years to protect the interests of rural America. We will continue to need your support and interest in this endeavor if we are to be successful. An important aspect of this effort is a viable REA program. From time to time legislative improvements are necessary to accomplish this objective. S.1300 provides needed and timely changes in this respect.

PURPOSES OF AND NEED FOR S.1300

Recognizing the ongoing need for a viable REA telephone program and the changing environment of the telecommunications industry occasioned by competition and new technology, changes in the Rural Electrification Act are both necessary and desirable.

It has been 10 years since this Committee last considered major revisions to the Rural Electrificiation Act. During this period, we have witnessed unprecedented inflation in our society which caused an inordinate drain upon the resources of the revolving fund -- far beyond the requirements for capital anticipated by Congress when the fund was created in 1973. The fund's main source of income, repayments from borrowers on outstanding loans, simply has not been adequate to meet the increasing demand for new loans authorized annually by Congress. In addition, as interest rates increased during this period, the interest expense on fund borrowing has escalated dramatically. The following chart provided by REA graphically demonstrates these points:

THE RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND (RETRF)
(Dollars in Millions)

LOAN PAYMENTS RECEIVED			RETRF OUTLAYS	
Fiscal Year	Principal	Interest	Advance to Borrowers	Interest Paid
1973	$ 20.3	$ 21.4	$ 92.4	$ 0.0
1974	173.1	144.2	802.4	0.0
1975	204.0	174.3	854.9	0.0
1976	299.2	252.3	1027.9	11.4
1977	275.2	234.9	874.9	29.6
1978	303.1	268.1	881.4	33.3
1979	313.8	296.9	1105.2	79.1
1980	349.1	336.9	1206.8	144.1
1981	363.1	382.7	1203.8	288.4
1982	389.3	425.8	1048.0	316.5

Source: Rural Electrification Administration, U.S.D.A.

These two factors, inflation and high interest costs, have combined to create a situation of imbalance which has caused REA Administrator Hunter to predict that by 1986 the amount of interest paid out by the fund will be more than the interest income it receives. This has prompted him to comment, "At that time, the revolving fund will begin eating its seed corn."

The financial resources of the revolving fund will be even further depleted when, in 1993, the fund will be required to begin repayment to the Treasury of the Administrator notes. These notes, amounting to 7.8 billion dollars, come due from 1993 to 2017. They were made liabilities of the revolving fund when it was created in 1973; however, no provision was made for their retirement or repayment in that legislation. These notes arose primarily in connection with the REA direct loan program which existed from the program's inception through 1972. Funds were appropriated each year by the Congress to meet the program's needs. The Administrator was authorized under the Act to "borrow" the necessary amounts from the Treasury for re-lending to program participants. As repayments were made under the program the Administrator would in turn satisfy his Treasury "notes", crediting the oldest notes first. This, of course, was largely a bookkeeping transaction since the repayments flowed directly from borrowers These two factors, inflation and high interest costs, have combined to create a situation of imbalance which has caused REA Administrator Hunter to predict that by 1986 the amount of interest paid out by the fund will be more than the interest

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The alternative recommended in S.1300 seems to us to be the most desirable and least costly. It would authorize retention of the notes as additional equity capital in the fund thereby making repayments by borrowers during this period available for program relending (at the levels authorized annually by the Congress) rather than for general government expenditures. It would be the least costly of the three alternatives discussed since it would not require any new budgetary outlays nor would it increase governmental borrowing.

An equally significant change will increase revenue to the fund by raising the interest rate to borrowers, upon enactment, to a rate necessary to balance the fund's interest expense and interest income. There is presently a 5% maximum statutory interest rate. This change, which our Association endorses, will ensure that all future "standard rate" loans from the fund will be made at the fund's cost of money. While we are striving to keep all of our costs at a minimum, particularly, interest costs, we recognize that preservation of the fiscal integrity of the revolving fund for future borrowers is also an important objective. This change should signify to all concerned that the participants in the program are willing to share in the responsibility for preserving the integrity of the fund.

These two changes incorporated in S.1300, capitalizing the Administrator Notes and providing for an adjustable "standard" rate of interest, will ensure a viable, balanced revolving fund for the forseeable future, reducing the need for additional borrowing or congressional appropriations.

S.1300 also provides several needed Act improvements in other areas. The Act will be updated to accommodate competition in the telecommunications industry, new technology, industry consolidation and further facilitate the transition to supplemental financing sources.

Competition

When the telephone amendment was adopted in 1949 the nation's rural telephone companies were fully regulated monopolies with protected service territories and assured revenue bases. For the most part, this meant stable rural telephone rates. With the implementation of FCC policies designed to encourage competition, this environment is rapidly changing. The traditional revenue base of the average rural telephone company is eroding due to competition and, frankly, no corresponding benefits are emerging. All of this works to the disadvantage of the rural ratepayer. If rural telephone rates are to remain comparable with their urban counterparts, rural telephone companies must be free to offer new or enhanced services which in some cases may be duplicative of other facilities. Yet, the Rural Electification Act currently prohibits loans which duplicate facilities. In those states where no regulatory commission exists, S.1300 would eliminate this prohibition permitting loans if other Act loans purposes are met. This is a needed improvement. This change does not preempt state regulatory jurisdiction, however, in any way. That authority is preserved in section 202 of the Act.

New Technology

The definition of "telephone service" in the Act was written 21 years ago in 1962. During the intervening years there have been dramatic advances in telecommunications technology: analog to digital switching equipment, fiber optics, and transmission of data as well as voice communications, to name only a few. S.1300 takes these technological changes into account in a new, improved definition of "telephone service" without disturbing the historical boundaries in the Act between telecommunications and CATV and broadcast radio.

Industry Consolidation

With the advent of competition, further consolidation in the telephone industy is inevitable. Presently there are almost 1500 companies furnishing telecommunication services in this country. Many are small rural companies in high cost areas which simply cannot economically support competition. The evolution towards consolidation began some years ago but it will be hastened by this new environment. Economies of scale will require that many service territories be consolidated. Many large telephone companies will also divest subsidiaries and territory as they strive to produce a more efficient, competitive operation. We are already seeing this take place in many areas. Bell operating companies have approached member companies of our association in past months seeking to divest operating territories which do not fit their future operating scheme. From the government's point of view, as well as that of the rural ratepayer, it is desirable for REA borrowers to be able to consolidate and effect operating economies in today's competitive environment. However, the Act currently contains limitations upon the ability of an REA borrower to acquire additional service areas with Rural Telephone Bank funds. S.1300 corrects this by eliminating the size limitations on acquisitions of exchange facilities which can be financed by the Rural Telephone Bank, an important change.

Another Act restriction upon the ability of REA borrowers to consolidate territories is the population limit of 1500 which is contained in the definition of "rural area." Excluded from financing are service areas of communities with over 1500 inhabitants. Often an REA-financed service area will surround one or more small communities in excess of 1500. However, financing is not available to serve these small towns because of the Act's population limit. Moreover, the utility serving the small town may want to consolidate territories with the outlying REA borrower but is precluded from doing so with REA loan funds. We believe the current limit of 1500 in the Act is outdated and that the increase to 2500 proposed by S.1300 is a reasonable and necessary change.

Transition to Supplemental Financing Sources

The Rural Telephone Bank legislation, enacted in 1971, contained the following statement of Congressional policy: "... the growing capital needs of the rural telephone systems require the establishment of a rural telephone bank which will furnish assured and viable sources of supplementary financing..." The Rural Telephone Bank has certainly lived up to its promise having loaned out over 1.5 billion dollars since its inception. However, one of the Act's existing provisions hinders its ability to accept additional graduates from the insured loan program and from further fulfilling its Congressional mandate. The Act requires that to be eligible for a bank loan a borrower must have the capability of producing net income or margins before interest at least equal to 150% of the interest requirements on all of its outstanding and proposed loans or such higher percentage as may be fixed by the telephone bank board to allocate available funds equitably among borrowers. The computation is made on a post income tax basis. S.1300 would expand RTB loan eligibility by permitting the bank board to lower the interest coverage test and to compute it before income taxes. This change would make the RTB more flexible so that more borrowers who are able to pay more than the standard rate of interest could qualify for RTB financing.

Also, by eliminating the reference to "1991" in the RTB capitalization section of the Act (sec. 406), the bank's authorized capitalization can be achieved without regard to a specified time limit. This means that if Congress defers appropriating a portion of the authorized capital in a given year for budgetary or other considerations that amount could be made up subsequently to achieve full capitalization of the bank.

Other important sources of supplemental financing for rural electric and telephone systems are provided through guaranteed loans and the accommodation and subordination to other lenders of REA's first lien on the property of the borrower. The changes suggested in S.1300 will materially improve the ability of borrowers to seek non-REA sources of financing. This is particularly important for telephone borrowers who must have the ability to finance for non-Act purposes as they seek to replace their eroding revenue base in the new competitive environment. One of these changes will direct the Administration to accommodate or subordinate liens or mortgages at the request of the borrower for any purpose that would improve the "efficiency, effectiveness or financial stability of the borrower" upon a finding that the borrower has, or will have, the ability to repay its debt.

Improvements in the guaranteed loan program recommended in S.1300 will make it more flexible and viable as a supplemental source of financing.

Finally, Madam Chairman, I want to mention a change which falls simply into the category of a desirable Act change.

S.1300 provides that the revolving fund be divided into separate electric and telephone sub-accounts. This division of the fund, while preserving overall program homogeneity, will better enable each program segment to stand on its own. Each program also will be better able to meet its future financial requirements in a changing environment through sub-accounts which will reflect each program's assets, liabilities, equity, income and expenses.

Overall, Madam Chairman, S.1300 makes many important and needed improvements to the Act and to each respective program. Our Association wholeheadedly supports its enactment. We trust that the subcommittee and full committee will act promptly to consider this important bill and report it favorably to the full Senate.

Statement
on behalf of the
UNITED STATES TELEPHONE ASSOCIATION

We believe that the changes in the Rural Electrification Act of 1936 proposed in S. 1300 constitute responsible and needed improvements in the REA program. They are particularly vital to the successful operation of the telephone program. In addition, we believe that S. 1300 is a sound approach to the problem of the imbalance in the revolving fund. It is certainly the alternative least costly to the government if we are to maintain a viable REA program and a fiscally-sound revolving fund for the future. USTA supports enactment of this important legislation and commends the sponsors for its introduction.

The telephone industry is currently undergoing unprecedented and dramatic change as a result of the court-ordered divestiture by the American Telephone and Telegraph Company of its regional operating companies and the access charge order of the Federal Communications Commission, scheduled to be implemented on April 3, 1984. In addition, our industry is witnessing almost unbelievable technological changes many of which cloud traditional distinctions between competing methods of communication. The age in which we live properly labeled "The Information Age" is an exciting time to be involved in the field of telecommunications. Exciting indeed, but monumental change creates uncertainty and, in a capital intensive industry like the telecommunications industry, uncertainty creates problems.

Fortunately, even in this revolutionary environment, the REA telephone program provides an important and stabilizing bulwark for rural telephone companies and their customers. Access to adequate capital is vital to a public utility. In high cost rural areas of our country, capital just would not be available if it were not for the lending programs of REA. The REA has made it possible for millions of rural Americans to have affordable telephone service of a quality comparable to the urban areas.

In authorizing the telephone loan program, Congress directed that it be conducted to "assure the availability of adequate telephone service to the widest practicable number of rural users". As of January 1, 1983, REA figures show that 1028 telephone company borrowers had over 7 million telephones in service providing service to 5.1 million customers, 84.2% of which have one-party service. To get this job done, REA has approved more than $6.7 billion dollars in loans and loan guarantees to finance 891,724 miles of line in 46 states to 258 cooperatives, 766 commercial companies and to 4 public bodies since the first telephone loan was made after enactment of the telephone amendment on October 28, 1949.

Approximately $1 billion already has been repaid. There has never been a default in the 34 year history of the REA telephone program. Truly, this is a record of which, as taxpayers, we can all be proud. However, it should be noted that the companies providing this service still only have an average net worth of 26%.

As I mentioned, the job is not over. In many respects, it may just be beginning. The need for capital has never been greater in our industry. The technological revolution which we are experiencing will make much of our existing plant and facilities obsolete. To meet the new demands of competition in our industry, upgrading of our equipment is necessary if we are to provide the equal interconnection access envisioned by the FCC. And, there are still unserved households in rural America -- some estimate as many as 5 million or more without telephone service. Hence, the REA telephone loan program serves the public interest as much if not more than ever.

It is, of course, equally important that the Act itself keep pace with the times. The last major revision of the Rural Electrification Act occurred in 1973 when the insured and guaranteed loan programs were created along with the revolving fund.

Since then the revolving fund has served as the sole source for REA insured loans. Repayments of principal and interest by borrowers together, with the sale of certificates of beneficial ownership (CBOs) to the Federal Financing Bank have provided the required funds for new loans. The fund was originally designed to be largely self-sustaining but high interest costs and greatly accelerated capital needs occasioned by inflation have eroded the capital base of the fund. By 1986 it is likely that the fund will move into a deficit position requiring a drastic reduction in loan availability, increased costs of borrowing or some further legislated assistance.

S. 1300 provides a remedy now by increasing the interest rate to borrowers by the amount necessary to balance the fund's interest expense and by exchanging the outstanding notes to the Treasury when they begin coming due in 1993 for additional equity capital in the revolving fund. This would mean that borrower repayments of principal and interest would be retained as capital within the fund for re-lending under the program rather than being generally available for other government expenditures.

There is no giveaway here. These funds will continue to remain in the U.S. Treasury until they are authorized for re-lending by the Congress.

All REA borrowers will repay their loans just as they always have. No obligation is being forgiven and no right is being lost by the government. It is simply a matter of maintaining the financial integrity of the revolving fund by providing the capital from borrower repayments rather than additional borrowing from the Treasury or the private market or for additional Congressional appropriations. Capitalization of these outstanding notes restores the capital base of the fund and assures a continued commitment by the Congress to rural America through this important program.

Other changes proposed in S. 1300 are necessary to integrate into the Rural Electrification Act the mandate for competition in our industry ordered by the FCC. The Act was written when borrowers all had territoral protection for their exclusive service areas as regulated monopolies. Indeed, to preserve government resources, a finding of non-duplication of facilities was required as a prerequisite to the making of an REA loan in those states without a state regulatory commission. In a competitive environment, of course, there must be duplication of facilities; therefore, this prohibition has been eliminated. This will be particularly helpful in converting much of our present switching equipment to the more sophisticated digital type to permit equal access to our local service territories to common carriers, other than AT&T. This change, however, does not affect, in any way, state authority to regulate telephone service which is preserved in Sec. 202 of the Act. There is no preemption of state authority in the bill and in those states with a regulatory body to regulate telephone service their authority would continue as under present law.

Another updating provision S. 1300 is Section 3 which, revises the definition of "telephone service" to specifically include transmission of "data". It also substitutes for the requirement that electricity be utilized between the transmitting and receiving apparatus references to modern transmitting methodology of fiber optics and light as well as radio or other visual or electromagnetic means. These changes will bring the statutory definition of "telephone service" in line with current technology.

Another change in this section would permit REA loans to be made to serve inhabitants of cities, towns and villages of 2500 or less, increasing the current statutory limit from 1500 or less. This change is necessary to consolidate service territories which in many areas have a small town or village in their midst. Under current law, the Administrator cannot make a loan in such an area even though it logically falls within a borrower's natural local service territory. This is a real handicap in the current environment, since consolidation of territories is desirable and necessary if many small companies are to continue to have a viable revenue base.

Up to now, over 60 percent of the average REA company's revenue has come from long distance calls. With interstate long distance competition and the loss of traditional long distance settlement procedures, that contribution of revenue can no longer be counted on and will eventually erode. If reasonable local service rates comparable to the rest of the country are to be maintained in these high cost, rural areas of our country consolidation of territories must occur. REA will be a participant in this proces since they hold a first mortgage on all of the property of these borrowers and therefore, would be the only available financing source.

Another change which will facilitate desirable consolidation of service areas is the elimination of the statutory limitation on the size of acquisition which can be financed by the Rural Telephone Bank. Current law provides that, in acquisitions involving local service exchange facilities, the borrower cannot acquire a system greater than its own at the time of its first loan from REA.

Also, eliminated would be a little-used procedure requiring the Secretary of Agriculture to approve pursuant to a finding, in RTB loans for other acquisitions of "telephone lines, facilities or systems", that the location and character of the acquisition is such that it will improve the efficiency, effectiveness or the financial stability of the telephone system of the borrower. This duplicates a similar requirement imposed upon the Governor of the Telephone Bank under existing Section 408(a)(2).

When the Rural Telephone Bank legislation was adopted, it was contemplated that borrowers who were at lower interest rate levels would graduate to the higher interest rate capital of the Rural Telephone Bank as their system became more financially stable. Unfortunately, the needs test was written in such a way that the RTB had little flexibility in qualifying additional borrowers for bank loans. One of the problems has been the interest coverage test which was statutorily established at 150%. The board was given the authority to raise the percentage but not to lower it to qualify additional applicants. This has resulted in a disincentive for a bank loans to borrowers. The problem is corrected in S. 1300 by authorizing the Bank board to lower as well as raise the interest coverage ratio to qualify addditional borrowers. Another change requires the board to compute the ratio on a pre-income tax basis rather than a post-tax basis bringing the test more into line with commercial lending practices.

These two changes will combine to produce a more flexible RTB lending program in furtherance of the Congress' original objectives in establishing the Rural Telephone Bank.

Two additional changes, affecting both the electric and telephone programs merit specific comment. One proposes to divide the revolving fund by creating separate electric and telephone sub-accounts. This is a sound change since it will require that each program stand on its own and yet not disturb the traditional homogeneity of the REA program. There will still be only one revolving fund within the U.S. Treasury but each program will be accounted for separately. The second, and more dramatic change for the telephone sector, is the improvement suggested in the guaranteed loan program section of the Act (sec. 408). The Administrator is directed, under S. 1300, to provide financial assistance to borrowers through guaranteed loans or by accomodating or subordinating liens or mortgages to encourage and assist borrowers to develop and achieve necessary financial strength to satisfy their credit needs from other sources and to improve their financial stability. In addition, the Administrator shall accomodate or subordinate, at a borrower's request, for any purpose that would enhance its financial strength or improve its efficiency, effectiveness or financial stability upon a finding of an ability to repay by the borrower. It is vitally important to the welfare of telephone borrowers that these changes be made.

We have referred to the necessity and desirability of consolidation in the telephone business in the present deregulation environment. Just as important is the need to diversify to offset revenue losses in traditional telephone service operations. If rural consumers are to benefit at all from deregulation and competition in the telephone industry, then telephone companies must be permitted, even encouraged, to diversify their operations. The restrictive administrative policies of the present Administration are the most significant deterrent to the successful diversification of REA telephone borrowers. Since REA has a lien on all property of the borrowers (whether now owned or hereafter acquired) diversification of plant and facilities cannot occur without the cooperation and approval of REA. Up to now, this cooperation and approval has not been forthcoming. This change would ensure that this dilemmna of REA borrowers is alleviated.

In summary, the changes in the Rural Electrification Act proposed in S. 1300 are important and desirable improvements. They would strengthen and enhance the insured and guaranteed loan programs of REA. They would ensure that the revolving fund remain fiscally sound and financially solvent for the foreseeable future without the need for the injection of further capital. Most importantly, the Act would signal to those in rural American that the Congress is not shrinking from its commitment made long ago when it passed the Rural Electrification Act that those living in sparsely-populated sections of our country will have dependable and affordable electric and telephone service. In this "Age of Information" dependable communications is not a luxury, it is a necessity.

STATEMENT OF

ROBERT J. MULLINS
DIRECTOR
LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

Madam Chairman and Members of the Subcommittee:

I am Robert J. Mullins, Director of Legislative Services for the National Farmers Union. On behalf of the farmer and rancher members of the National Farmers Union, I appreciate the opportunity to lend the support of the Farmers Union to S. 1300. As you know, Madam Chairman, we in the Farmers Union have been long-time supporters of the Rural Electric and Telephone Systems since a vast majority of our members rely upon these member-owned cooperatives for their electric and telephone services. We believe the legislation embodied in S. 1300 will allow these cooperatives to continue, in an economically secure manner, their services to rural America.

One hour of farm labor today produces 14 times as much food and other products as it did 60 year ago.

Certainly, intensive and continuing research accounts for a good share of this spectacular boost in fundamental productivity. But it is clear also that the increase owes much to the fantastic improvement in the efficiency of the American farmer during this time.

And it surely is not coincidental that these 60 years fairly well duplicate the development of a rural electrification program that has added the hum of electric power to the sweat and muscle of man.

It is not possible to measure precisely what this has meant to all of us in this country, but it is possible to measure some things here and there.

Simply as examples, let me point to these: Today's agriculture in the United States is the largest commercial industry in the world, providing jobs for 23 million people, more than one-fifth of our total labor force; food costs now take less than 17% of our average disposable income, a strikingly modest figure compared to the 60% to 70% required for the same purpose in some countries.

Much more could be said about the remarkable gains in agricultural productivity in this country, and what these gains have meant in dollars and cents, in healthful comfort and security, to all of us. This should be sufficient, however, to emphasize the need for maintaining this abundance, the farm system that has produced it, and the dependable source of power that has helped so mightily to advance both to where they stand today.

These are the concerns that move us without hesitation to offer full support for the proposals of America's rural electric cooperatives, as embodied in this bill.

Cognizant of the need for a strong rural electrification and telephone system in this country, the delegates to the 1984 national convention of the Farmers Union, held March 12-14 in New Orleans, Louisiana, adopted the following statement relative to rural electrification and telephone service:

> "M. Rural Electrification and Telephone
>
> "The establishment of federally sponsored rural electrification and rural telephone cooperative systems not only helped American agriculture increase its productive capacity, but also generated demand for goods and services that spurred production and employment across the nation.
>
> "The ability of these cooperatives to continue supplying reliable and affordable services to farms and other sparsley

populated areas of the nation hinges on their ability to acquire adequate capital.

"The revolving fund and loan guarantee programs made available to electric cooperatives by the Rural Electrification Administration (REA) and the low interest loans and guarantee programs available for rural telephone service have proven to be effective and efficient means of meeting these financing needs. Revolving funds and loan guarantee programs are available at no cost to the American taxpayer.

"National Farmers Union supports continuation of strong rural electrification and telephone programs and urges the Congress to preserve and continue the financing now available through REA and the Rural Telephone Association. We ask Congress to authorize funding levels to be made available through these programs, adequate to meet the capital requirements of rural electric and telephone systems.

"The most essential immediate step for the Congress to take is to enact the 'Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act', which would balance interest income and interest expense in the Revolving Fund, and assure the long-term solvency of the system."

The start of the 60-year period I have referred to saw almost all of the rural areas of this country without electric power, and without it there was no prospect at all of a powered agriculture and all of the benefits we have seen it produce.

We know very well the story of how electrification finally came to the back roads of this country, and we know just as well that the form in which it came -- user-owned and -controlled, nonprofit cooperatives -- had every thing to say about its dependability and economy throughout the past half-century.

Progressive agriculture needed that steady assurance that its new electric service would be fully reliable and that it would be as economical as it was possible to make it across the thinly-populated areas of rural America. It was understood then as now that these necessary conditions had their best possibility of achievement through people-owned organizations which had no need or incentive to sell electricity for any reason other than to serve themselves.

Rural electrification in this country, through all of the last 50 years, has grown hand-in-hand with our growing agriculture. As farm and other rural needs for electric service have grown, the user-owned rural electric systems have grown steadily to meet those new needs.

In our view, it is vital to preserve this reliability, this continuing assurance that our concerns are their concerns.

We know that rural electric cooperatives, like all electric utilities of every sort, always will have need for access to capital on the best possible terms. The Rural Electrification Administration's revolving fund has met these needs well and can continue to do so if it is protected from a continuing imbalanace between interest income and outgo. We endorse S. 1300 as a sound means to this end.

State of North Dakota
EXECUTIVE OFFICE
BISMARCK

November 18, 1983

The Honorable Paula Hawkins
United States Senator
Room 147, Dirksen Office Building
Washington, D.C. 20510

Dear Senator Hawkins:

As Governor of North Dakota and as chairman of the Western Governors' Policy Office (WESTPO) I request that the enclosed Statement of Record be filed with your subcommittee on Agricultural Credit and Rural Electrification in support of the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983, S.1300.

This legislation is essential to the financial integrity and self-sufficiency of the REA Revolving Fund, it is important to the 25 million rural consumer members served by electric and telephone cooperatives and is supported by the 13 governors of the WESTPO states.

Your committee's favorable action on S.1300 will be very much appreciated.

Kindest regards.

Sincerely,

Allen I Olson

ALLEN I. OLSON

Enclosure

Statement of record
Governor Allen I. Olson

It is a privilege for me to submit this statement as governor of my state, North Dakota, and on behalf of the governors of the 12 western states making up the Western Governors' Policy Office (WESTPO), which I chair, in support of the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983, S. 1300.

The enactment of this legislation is essential to the financial integrity and self-sufficiency of the REA Revolving Fund. This legislation will enable the rural electric and telephone cooperative systems to continue providing reliable, central station service to rural America. This legislation is of the upmost importance to the 25 million agricultural and rural area consumer members being served by electric and telephone cooperatives and it is for that reason that I appear before you today on behalf of my state and representing the governors of 12 other western states comprising almost one-half of the total United States land area. We are also the states with the lowest population density of any in the country.

The provisions of the legislation which provides for periodic adjustment of the interest rate applied to new REA insured loans is the key to preserving the financial stability of the Revolving Fund. While this change would result in an increase in the financing costs borne by REA borrowers, we believe strongly, however, that this is a price worth paying to assure the long-term future viability of REA financing.

Another very important element of the overall proposal contained in this legislation is for Congress to convert the funds originally appropriated for REA lending prior to 1973 into a permanent capital investment in the Revolving Fund. Without this change the rural electrification administration will be required to transfer this capital from the Revolving Fund to the Treasury through annual installments beginning in 1993. This requirement could add significantly to the cost of providing electric service in rural America. The proposed conversion of approximately $7.9 billion into a permanent capital investment in the Revolving Fund would not impact on the federal budget.

Recent public attacks on this legislation falsely imply that rural electric systems are heavily subsidized, and that the loans REA has made to them will never be repaid. Both assertions are false and need to be knocked down wherever and whenever they appear. It is absolutely clear that nothing in the proposed legislation would result in the "forgiveness" of any debt. Both the Revolving Fund and the Treasury are the property of the government and the people of the United States. The proposed legislation would not in any way reduce the principal or interest amounts to be paid on any loan made by REA to rural electric borrowers. Not a single penny of REA lending would be "forgiven" under the proposed amendments to the Rural Electrification Act pending before this Congress.

It is important to my state, North Dakota, and other great plains and western states that this legislation provide a mechanism for helping electric and telephone systems providing service under especially difficult circumstances. Strong justification exists for giving special consideration to the relatively few systems that operate under extreme hardship due to the nature of the territories they serve, damage from storms or other natural disasters, or the financial condition of their consumers. For this reason, I, along with my fellow governors, support language that would provide for a special interest rate loan program, including authority for the REA administrator to make loans under conditions of natural disaster and other hardship at lower, special interest rates of no less than two percent.

Three primary conditions necessitate this special provision. Rural electric and telephone systems in the State of North Dakota and other western states frequently suffer severe damage caused by sleet and wind storms. This damage most often occurs in areas having an average consumer density of two or less per mile, and occur in geographic areas having low per capita income forcing the rural cooperative into extreme financial hardship. Therefore, we believe that amendments are needed to meet these special needs of borrowers operating in very difficult economic circumstances, particulary those serving sparsely settled rural areas.

This Nation's agricultural industries are highly energy intensive. Our farmers and ranchers are acutely aware of the critical interdependence between this Nation's agricultural productivity and the need for adequate supplies and dependable sources of energy. The creation of the Rural Electric Cooperative program, nearly a half century ago, was to epitomize one of the most successful partnerships to form between this government and its citizens. Since its creation, the Rural Electrification program has provided rural America with dependable and reasonably priced electric power. The availability of this energy to rural America is today as indispensable to the economic health and vitality of this Nation and to the continued capacity of the American farmer to produce the food and fiber required by this country and the world as it has been in the past.

Agriculture is America's national treasure. The benefits that electrification has brought to rural America, in creating jobs, in alleviating the drudgery that consumed many farmers' waking hours, in enhancing rural life and in contributing to the most productive agricultural economy in the world, more than outweigh the relatively small costs of this program. If rural electric cooperatives are to continue their contributions to rural America and are to meet our energy needs for the future and if rural telephone cooperatives are to continue to meet the communication and high technology needs of our farmers it is vital that they also have access to the capital that is required to conduct their operations. Our great American agricultural production machine continues to contribute to the reduction of this Nation's dependence on foreign oil and to the achievement of energy independence for the future. Our rural electric and telephone cooperatives play a vital role in maintaining the dependability and reliablity of American agriculture.

I thank the committee for the opportunity to submit this statement on behalf of the governors of 13 WESTPO states in support of the amendments to the Rural Electrication Act as a responsible and reasonable response to the needs of rural America.

WESTPO GOVERNORS

Alaska
Bill Sheffield

Arizona
Bruce Babbitt

Colorado
Richard D. Lamm

Idaho
John V. Evans

Montana
Ted Schwinden

Nebraska
Robert Kerrey

Nevada
Richard H. Bryan

New Mexico
Toney Anaya

North Dakota
Allen I. Olson

South Dakota
William J. Janklow

Utah
Scott M. Matheson

Washington
John Spellman

Wyoming
Ed Herschler

APRIL 12, 1984, HEARING

STATEMENT OF HON. WALTER D. HUDDLESTON
A U.S. SENATOR FROM KENTUCKY

Madam Chairman, the legislation before us today was introduced last May. From the very beginning, the Administration has opposed this proposal.

Although the Administration acknowledges there is a need for legislation that addresses the problems of the Rural Electric and Telephone Revolving Fund, the Administration has failed to provide Congress with a legislative proposal. I believe that, if the Administration has a better solution to the problem than the one provided by this legislation, it should have been made available to Congress before the House completed exhaustive hearings on H.R. 3050 last October and approved that legislation by a vote of 283 to 111 on March first of this year, and certainly prior to this Committee's conclusion of hearings.

Rather than directing its energies toward working with Congress to develop a constructive solution to the problem, the Administration has instead chosen to distort what this legislation will do and what it will cost.

For example, during the Committee's first hearing on this legislation, the Administration's chief witness, Mr. Frank Naylor, repeatedly stated that this legislation will cost $21 billion. When I pointed out to Mr. Naylor that the Congressional Budget Office did not agree with his estimate, he responded that the Committee should review very carefully later determinations that both the Congressional Budget Office and the General Accounting Office made, indicating that they very strongly supported his position.

Mr. Naylor's statement may have left the members of this Committee with the impression that CBO and GAO agreed with him that this legislation will cost $21 billion. That is simply not true. Nowhere in the updated CBO or GAO analyses before us today is it stated that the cost of this legislation is $21 billion.

The fact is, CBO estimates that the total cost of S. 1300, over the 25-year period starting in 1985, will be $10.5 billion. It is my belief that the real cost of S. 1300 is much lower because, without this legislation--under which REA borrowers will be making a significant contribution toward balancing the Fund--Congress would have to appropriate funds during the same time period that would exceed $10.4 billion if REA is to continue providing financing at present levels. In addition, those appropriations would have to begin very soon because, as presently operated, the fund will be unable to make loans after 1990.

In regard to one of the primary objectives of the legislation, the Administration and others contend that the interest rate formula provided under S. 1300 will not ensure that interest income will equal the interest expenses of the revolving fund. I have indicated in the past that I would support an appropriate amendment that would make certain the fund will be managed so that interest income will equal interest expense.

In a letter I sent to the Comptroller General on February 23, I requested him to provide recommendations on how to make certain the fund could be balanced. Unfortunately, GAO has not responded to me and this issue is not directly addressed in GAO's written testimony.

I would note however, GAO representatives have told my staff that an amendment such as the proposal that was offered in the House by Congressman Stenholm would ensure that the interest rate formula provided under S. 1300 would balance the fund.

Madam Chairman, not that we are about to conclude the hearing process on this legislation, I intend to request that Chairman Helms schedule a markup of this legislation. I believe this legislation is essential to rural America and I will make every effort to see that it is considered in a timely manner.

I look forward to reviewing the testimony of today's witnesses.

I ask that a copy of my letter to the Comptroller General be made part of the hearing record.

United States Senate
COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON, D.C. 20510

February 23, 1984

Honorable Charles A. Bowsher
Comptroller General of the United States
Washington, D.C. 20548

Dear Mr. Bowsher:

It is anticipated that the Subcommittee on Agricultural Credit and Rural Electrification of the Committee on Agriculture, Nutrition, and Forestry will be holding hearings, in the near future, on S. 1300, the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983. The General Accounting Office has already done a substantial amount of work in analyzing the bill and reviewing the activities of the Rural Electrification Administration, which will be of benefit to the Subcommittee in its consideration of this important legislation.

In preparation for the hearings, the General Accounting Office has provided the Subcommittee with a preliminary draft of its statement on S. 1300. The GAO draft statement discussed several matters that, I believe, should be analyzed further by the General Accounting Office prior to the hearing.

First, with respect to the amount of Federal assistance made available to investor-owned utilities (IOU's) compared to rural electric cooperatives (REC's), the draft statement did not indicate that GAO calculated the lost revenue attributable to tax-deferred dividend reinvestment plans as Federal assistance for IOU's. In fact, the draft document says that this benefit "does not appear to be significant". According to the Department of the Treasury, the total cost of this tax benefit for IOU's will exceed $1.6 billion, a sum that I consider quite significant. While tax incentives of this nature are provided to achieve specific national objectives, the losses to the Federal Government from this incentive should be considered in any comparative analysis of Federal assistance.

Further, in comparing the Federal assistance provided to REC's and IOU's, the draft statement calculates the amount of subsidy to REC's involved in their receiving 5 percent loans from the Rural Electrification Administration (REA). Since that type of direct loan makes up only about

20 percent of the REA program, I don't believe it is correct to use the 5 percent loan program as a basis for making dollar-for-dollar comparisons of Federal assistance provided to REC's and IOU's.

Second, the draft statement says that, since the Rural Electrification and Telephone Revolving Fund was established in 1973, the subsidies provided through REA loans have cost the taxpayers $8.2 billion. However, according to REA reports, the total amount advanced through the revolving fund was just over $9 billion at the end of fiscal year 1983. Because the draft statement seems to imply that the cost of providing assistance in the form of grants would not be much greater than loans that are repaid with interest, it would be helpful for GAO to provide a more detailed analysis of taxpayer costs incurred, after the fund was established, as a result of loans made through the fund.

Third, while the GAO acknowledges that S. 1300 would reduce Federal interest subsidies in order to improve the financial condition of the revolving fund, the draft statement says that the interest rate provided for by the formula under S. 1300 will not be high enough to balance the fund. My intent, in developing S. 1300, was to make the revolving fund self-sufficient by making certain that interest expenses will not exceed interest income so that a direct appropriation of moneys to the fund will not be required at some time in the future.

I believe that S. 1300, as introduced, accomplishes this objective; however, if it does not, I will want to make appropriate modifications in the bill to make it clear that the fund will be managed in such a way as to be self-sufficient. Therefore, it would be useful to have a more detailed analysis by GAO of the interest rate formula and any recommendations for modification of the formula so that the formula, coupled with the other changes in the REA program under the bill, will ensure that interest expenses will not exceed interest income to the fund.

I request that the General Accounting Office review the matters I have raised, and take appropriate steps to address these issues.

Sincerely,

Walter D. Huddleston

Walter D. Huddleston

STATEMENT OF HON. EDWARD ZORINSKY
A U.S. SENATOR FROM NEBRASKA

I want to draw the Subcommittee's attention today to the need for the Rural Electrification Administration to relax its lien accommodation policies to enable small, rural telephone companies that borrow from REA to supplement those loans with commercial financing without harming the government's security. It is most important that the REA change its policy so that the agency shares or subordinates its liens with other, private lenders.

With the advent of competition, deregulation and new technology in the telecommunications market, the destiny of many rural telephone companies rests with their ability to diversify. Unless REA, to which many of these small systems are mortgaged, is willing to share its lien with other lenders, small telephone companies will find themselves in a bureaucratic "Catch-22" that will result in rural residents again being left behind.

The original intent of the RE Act, which encouraged outside financing for projects REA is financially unable to, or prohibited from financing, will have been thwarted.

Today, REA policies regarding lien accommodations effectively prevent borrowers from obtaining private funds. While the REA Administrator has discretion over whether the agency will share its lien, REA has only granted lien accommodations if the borrower has proved it has adequate security and provides the government with a "compensating benefit"--usually prepayment of an existing loan or agreement to a reduction in the term of the loan. Negotiations between REA and the borrower have been known to go on for years.

The less restrictive lien accommodation policies set forth in S. 1300 are most appropriate. Under the bill, the REA Administrator would be required to grant lien accommodations for any purpose that would enhance the financial strength of the borrower, improve its efficiency or enhance its financial stability, if the Administrator found the borrower had the ability to meet its existing obligations.

This change in REA policies would enable telephone borrowers to supplement REA loans with commercial market borrowings without threatening the government's security. It would strengthen the government's security by allowing REA borrowers to obtain funds necessary to diversify into more lucrative telecommunications-related ventures, thus ensuring their future viability.

STATEMENT OF HON. HOWELL HEFLIN
A U.S. SENATOR FROM ALABAMA

Madam Chairman, members of the committee, I am pleased to speak in support of S. 1300, the Rural Electrification Administration Revolving Fund Self-Sufficiency Act of 1983.

REA's impressive history in extending utility service to rural America is well-known. Many Senators can recollect the very day that the lights went on, or the telephone went in, in rural homes. In Alabama, REA has provided telephone services for over 125,000 persons since 1950. Alabama borrowers have repaid nearly $50 million in REA loans, including over $44,000 that was repaid ahead of schedule. This is, indeed, an excellent record.

The issue before us today, however, looks not to the past, but to the future. Does Congress believe that there is still a need for REA? In speaking with my constituents, the rural telephone and electric borrowers and the customers they serve, I must answer this affirmatively.

The need for the rural electrification and telephone program is no different today than it was when the program was created 49 years ago. REA is needed to improve the productivity and quality of life in rural America by ensuring that all rural citizens have access to an adequate and reliable supply of electric energy at a cost reasonably comparable to that paid by residents in cities and towns.

Congressional action is needed to strengthen and maintain the REA Revolving Fund. This major capital source for Rural Electric and Telephone Cooperatives will soon become insolvent if S. 1300 is not enacted by the Senate. The reason is that the Fund must pay the Federal Financing Bank a much higher rate of interest than the 5 percent that it currently loans to cooperatives under the formula established by Congress.

This legislation authorizes the REA Administrator to gradually raise the rate on insured loans from this 5 percent level. The Committee should bear in mind that the co-ops already raise 30 percent of needed financing on the open market. As to the role of government subsidizing electric service to rural areas is concerned, I contend that there is a valid reason for government involvement in these areas. We must consider the positive role that agriculture and other rural-based industries plan in the economy of the nation and typically these areas are the most difficult and expensive to serve for both electric and telephone utilities. Without continued low cost financing for these rural utilities, economic growth in rural America will be restricted.

Madam Chairman, we must also consider the deregulation of the telephone industry and the break up of AT&T that have had a negative impact on rural telephone subscribers. They will see their local rates increased two and three times in some cases, as a result of these industry changes. This is because under the FCC's new access charge scheme, local telephone systems lose an important source of revenue. To survive in this deregulated environment, small rural telephone systems need the continued financial support of the REA program. They also need the flexibility to make sound management decisions which will strengthen their financial base.

The opportunity to become involved in diversified ventures, such as to provide interconnect services is one way small telephone systems can remain viable. However, REA policies with regard to sharing REA's first lein on borrowers' properties make it virtually impossible for borrowers to obtain the financing they require for such sound investments. S. 1300 proposes a realistic lein accommodation policy to meet the challenges of today's telecommunications world.

We cannot allow the advances we have made in extending telephone service to the entire nation, advances made only because of the existence of the REA telephone loan program, to be reversed. REA has an important role to play in ensuring that universal telephone service, to which we are committed by law, will be maintained.

Rural telephone systems need to maintain and upgrade their systems, to remain viable in this new era of telephone deregulation. They cannot do so without the continued assistance of REA.

Clearly, Madam Chairman, the REA program, as improved by S. 1300 would inject tremendous stability in a period of great uncertainty for rural electric and telephone subscribers. REA's traditional support of rural electrification and telecommunications is therefore most important at this time.

STATEMENT OF HON. QUENTIN N. BURDICK
A U.S. SENATOR FROM NORTH DAKOTA

Madam Chairman, thank you for this opportunity to comment in support of S. 1300. I think this bill represents a reasonable attempt to keep the REA loan programs for electric and telephone borrowers viable. This bill is probably not a solution for all time. Things change. The needs of our rural electric and telephone borrowers change over time. Technology changes. Economic conditions change. Rural lifestyles change. The general energy situation is constantly changing. We live in dynamic and somewhat dramatic times. S. 1300 fashions a reasonable mechanism for financing rural electric and telephone systems through changing times. At some time in the future, we may have to rework the loan programs again. However, for now, S. 1300 is the way to go, I believe.

For most of our nation's rural electric and telephone cooperatives, there is no alternative to REA financing. I have the advantage over the Members of this Committee in that I remember very clearly when the original REA Act was enacted. I do not remember anything in the charter for REA that said when 99 percent of the farms and rural homes in America have electricity, REA is to cease to exist. When the telephone program was added later, I do not remember anything in its authorization indicating that it should cease to exist when most of the farms and rural homes had a telephone. REA is supposed to see that rural Americans have continuing access to electric and telephone service.

In April of 1952, the William J. Neal Power Station was completed and went on line in my state. The plant was rated at 42 megawatts, and at the time it was the largest pulverized lignite burning plant in the United States, and it raised North Dakota's generating capacity by one third. An $8.5 million loan from REA made it possible.

Today, the William J. Neal Station is dwarfed by several other lignite burning power projects in North Dakota, also financed by REA. The Neal Station is still operating at its rated capacity today. But that is far from meeting today's needs.

In the past thirty years, REA has financed service to thousands of new residences and businesses in my region of the country. Distribution and transmission systems have been improved to provide more reliable service. Facilities have had to be replaced because they were outgrown, or had otherwise exhausted their useful life. These enormous investments have been completely debt financed.

I do not know what the future holds. But I can say that if rural electric and telephone cooperatives, then REA must provide an adequate source of financing. Cooperatives are nonprofit, and are usually completely debt financed. Typically, equity levels for cooperatives are very low--too low to be able to borrow money in the amounts needed from what is referred to as the traditional money markets. In many cases, without REA, cooperatives would have to convert to investor-owned utilities and sell stock to raise enough equity to attract loan funds. Those who say that REA no longer needs to finance rural electric and telephone cooperatives are attacking the very existence of cooperatives.

The Federal Government subsidizes all electric utilities. Investor-owned utilities and municipally owned utilities are subsidized through the tax system. Rural Electric Cooperatives are provided an important interest rate subsidy. I know that this Committee has access to the data comparing the various subsidy levels. If Cooperatives are cut off from REA financing, and many of them convert to investor-owned utilities, the taxpayer could be providing a subsidy that is even more costly.

Finally, I know that the Members of this Committee believe in the value of competition within the nation's various industries as much as I do. If Rural Electric Cooperatives, municipally owned electric utilities, and investor-owned electric utilities are going to provide competition for each other on a somewhat level playing field, the REA will have to provide a viable financing program for cooperatives.

Madam Chairman, I believe the need for REA financing of cooperatives will continue to exist. And, I believe meeting that need serves our national interest. I hope that S. 1300 will be enacted into law.

STATEMENT OF HON. ARLEN SPECTER
A U.S. SENATOR FROM PENNSYLVANIA

Thank you, Madame Chairman. I appreciate this opportunity to come before the Subcommittee to speak in favor of S. 1300, the Rural Electrification and Telephone Self-Sufficiency Act. After consulting with the Rural Electric Association of Pennsylvania and its distinguished President, Mr. Bill Matson, I am submitting this statement in favor of S. 1300 in order to assist REA in providing electrification to Americans who live in rural areas.

Rural electric cooperatives have helped to transform the lives of tens of thousands of farmers and other rural residents. When the quality of their lives prior to the widespread availability of electricity was compared to that of their city cousins, rural people were clearly second-class citizens.

Rural electric cooperatives were established in Pennsylvania when the private power companies were unable to provide adequate service at reasonable rates. With the help of the Rural Electrification Administration (REA), the Commonwealth's rural electric cooperatives extended central station electric service, as far as possible to every corner of the state: to every farm, every rural residence, every small business, and every hunting camp that was previously denied the benefits of electricity. Today, rural electric cooperatives serve over 600,000 consumers in 41 of Pennsylvania's 67 counties.

Although rural electric cooperatives in Pennsylvania have grown and prospered, they still need the assistance that the REA can provide because they continue to face many of the same problems that co-ops faced 50 years ago when they were established. They continue to serve the most remote, the most rugged, and the most sparsely populated areas of the state. They continue to experience greater distribution investment per line mile than the private power companies, yet they receive less revenue per line mile than the power companies. And, from a competitive standpoint, it is my understanding that the rates of almost all rural electric cooperatives in Pennsylvania are higher than those of the neighboring power companies. In one case in Pennsylvania, I am informed that co-op rates are double those of the neighboring power company.

Much has been said before this Subcommittee and during the House consideration of the companion bill to S. 1300 about the history and operations of the REA financing programs. I will not cover that ground again, except to say that these programs have generally worked well and they merit Congressional efforts to work out the problems they now face.

S. 1300 deals with the problems of the REA financing programs effectively.

We in the Congress are not being asked to provide a "quick fix." Rather, we are being asked to consider a well thought out plan that was developed after months of careful study.

This plan does not ask for increased federal assistance. Instead, REA borrowers have proposed that their financing costs be increased so as to assure the future stability of the Rural Electrification and Telephone Revolving Fund.

This plan does not ask for a bailout. Instead, it asks that $7.9 billion in notes payable from the Revolving Fund to the Treasury be retained as permanent capital in the Fund; again, to provide for the future stability of the Fund. It is important to remember that the money represented by these notes is currently owned by the federal government and that the captial of the Fund will also be owned by the federal government.

This plan does not forgive any outstanding REA loans. All outstanding REA loans to distribution systems and generation and transmission systems will be repaid, as I understand it, to the federal government with interest. When considering S. 1300, I believe it is important to keep in mind the outstanding record of fiscal integrity that REA borrowers have established over the years. In the almost half century of its existence, REA has issued loans and loan guarantees totaling over $50 billion. Despite this large exposure, defaults have totaled less than $50,000 and the last default occurred more than 30 years ago.

Before I conclude, Madame Chairman, I must comment on the claim that has been made by opponents to this bill that it will cost taxpayers more than $20 billion. The facts show that this claim is just not true. This claim is based on several fallacious points:

- o The opponents claim that converting the notes due from the Revolving Fund to the Treasury represents a give-away. The fact, as I previously mentioned, is that the money represented by these notes is currently owned by the federal government and will continue to be owned by the federal government.
- o The opponents' claim is based on interest rates decreasing to 6.7 percent. In fact, the Congressional Budget Office has indicated that interest rates are likely to remain high, most likely over ten percent.
- o The opponents' claim is based on an assumption that all outstanding Treasury loans to REA and all loans guaranteed by REA will be refinanced and that they will likely be refinanced at terms that are costly to the government. In fact, language added to the House-passed version of S. 1300 provides that refinancing cannot occur without the agreement of the REA Administrator and the Secretary of the Treasury. Needless to say, these officials will not agree to terms that place the government at a disadvantage.

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Rural electric cooperatives are important to my state and the nation. They are important to all Americans in that the electricity they provide helps to produce the food and fiber that feeds and clothes our nation and that provides the food that helps to feed a hungry world. The REA financing programs helped to bring reasonably priced electricity to rural America 50 years ago. They are needed today to help keep electric rates in rural areas at reasonable levels. Unnecessarily increasing farmers' electric bills will only result in higher priced food and clothing for all of us.

In conclusion, Madame Chairman, I would like to ask that the Subcommittee expeditiously act on S. 1300 so that it can be brought to the floor for action by the full Senate. The bill represents a reasonable approach to solving the problems of the REA financing programs and it does so without adding to the burden of the federal budget or the federal deficit. Rural electric leaders have acted responsibly by bringing this solution to us. I believe we should act responsibly by enacting it.

Thank you Madame Chairman.

STATEMENT OF HON. DALE BUMPERS
A U.S. SENATOR FROM ARKANSAS

I want to thank the members of the Subcommittee on Agricultural Credit and Rural Electrification for holding hearings on S. 1300. The Senate must act quickly on the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act to guarantee continued electric and telephone service for rural Americans at affordable prices.

In its almost fifty years of existence, the Rural Electric Administration has fufilled its mission of providing electric and telephone service to rural Americans and has done so more efficiently than anyone would have imagined possible in 1936. Rural farmers and families have clearly enjoyed the conveniences of electric and telephone service, but the whole nation has benefitted from the increased productivity of American farmers and their contribution to the economic vitality of the nation. The REA directly reaches 25 million people in rural American and 260,000 Arkansas families, but its services benefit every American in some way.

Rural electric cooperatives face the high costs of providing service in areas of low population density. Although the REA has dealt with this problem well, the solvency of the Rural Electric and Telephone Revolving Fund administered by the REA is in jeopardy because of high interest rates of recent years. Congressional action is necessary now to ensure the solvency of the Revolving Fund and the availability of affordable telephone and electric service for rural Americans. If S. 1300 is not approved, the American farmer may face a crisis that will affect the whole nation.

S. 1300 would amend the Rural Electrification Act to ensure the financial integrity of the Revolving Fund by allowing the REA administration to adjust interest rates on REA loans to ensure that interest income balances interest expenses; converting Treasury notes that would fall due between 1993 and 2017 into equity capital for the revolving fund; and providing for lien subordination or accommodation to assist in obtaining commercial loans. I am proud to be a cosponsor of this measure, and I urge my colleagues to enact it. Rural Americans must have adequate and affordable power, and S. 1300 will help REA continue its fine record in providing that service.

STATEMENT OF THE HONORABLE THOMAS J. HEALEY
ASSISTANT SECRETARY OF THE TREASURY (DOMESTIC FINANCE)

Madam Chairman and Members of the Subcommittee:

I welcome this opportunity to present the Treasury's views on the financial provisions of S. 1300, the "Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983."

The Treasury Department has four principal concerns with the financial provisions of the proposed legislation:

(1) the proposal to forgive $7.9 billion of loans the Treasury has made to the Rural Electrification Administration,

(2) the proposal to lower the interest rates on loans made to REA and rural coops by the Federal Financing Bank, which is supervised by the Treasury.

(3) the proposal to provide for interest on loans made by REA at rates lower than the cost of Treasury borrowings to finance those loans, and

(4) the proposal to make REA guarantees an entitlement and to require subordination of loans held in the Fund, which could substantially increase the Government's exposure to loss and result in guarantees of tax-exempt obligations.

Under existing law, the REA direct loan program is financed by (1) $7.9 billion of borrowings from Treasury which were outstanding when the Rural Electrification and Telephone Revolving Fund was established in 1973 (the 1973 legislation repealed the requirement for the payment of interest to Treasury on this borrowing), (2) the sale to the Federal Financing Bank of certificates of beneficial ownership (CBOs) in the portfolio of direct loans, (3) authorized appropriations, and (4) authority to borrow from Treasury at current Treasury borrowing costs.

Borrowings from Treasury

Section 4 of the bill would repeal the requirement for repayment of the $7.9 billion of borrowings from Treasury. The Department is not aware of any justification for the proposed cancellation of REA debt. Moreover, since this additional $7.9 billion of financing for the program would be provided outside of the budget/appropriations process, it would constitute backdoor financing. Accordingly, the Department is opposed to section 4.

Borrowings from FFB

Section 5 would authorize the Administrator to repurchase without penalty CBOs sold to the FFB whenever the interest rate on an outstanding CBO is at least 100 basis points higher than the current FFB rate. Thus, in a period of declining market interest rates, the Administrator could continuously refund the entire portfolio of some $3.5 billion of CBOs at successively lower interest rates and then simply wait out any periods of rising market rates. This proposal -- which is a "heads you win, tails I lose" (that is, the taxpayer loses) proposition -- would provide substantial benefits to the fund at the expense of the FFB and the Treasury. As stated by the Congressional Budget Office, "This one-way, downward-only, penalty-free refinancing would benefit the Fund at the expense of Treasury, which does not have a similar refinancing option with investors in Treasury debt." Accordingly, the Department is opposed to section 5.

Section 7 would provide a similar rollover privilege for guaranteed borrowers from the Federal Financing Bank except that such rollovers could only occur once every 7 years. That is, if the current FFB lending rate were at least 1 percentage point below the rate on an outstanding guaranteed loan, the borrower could request that the loan be refinanced without penalty at the current FFB rate. This proposal suffers from the same criticism as the proposal to refinance CBOs discussed above.

On November 7, 1983, FFB and REA signed an agreement under which REA-guaranteed borrowers can fund projects with rollovers of short-term 2-year debt during the up to 35-year period when an advance is outstanding. Borrowers with short-term advances outstanding under notes signed prior to that date can elect to convert existing notes into the November 7, 1983, note form in order to obtain the flexibility to continue short-term roll-overs or to select a longer-term maturity for any advance. The new note form also provides for prepayment of advances by the borrower at any time at a market price, which could be a discount or a premium depending upon current market conditions. Thus, the language in the form of note in use now for the REA guarantee program is more flexible than the legislative language proposed in section 7 of the bill. At the same time, inclusion of market prepayment terms in the note recognizes the rights and obligations of all of the parties to the guaranteed loan contract.

REA lending rates

Under existing law, REA makes direct loans at 5 percent (the standard rate) and at 2 percent (the special rate). Section 6 would amend existing law to authorize the Administrator, from time to time, to establish the interest rate for new loans made during a given period so that the interest income from new loans just covers the Administrator's anticipated interest expense on new borrowings during that period. Standard loans would bear interest at the rate so determined, but not less than 5 percent. Special loans would bear interest at not less than 2 percent nor more than one-half the standard loan rate. We understand that the effect of section 6 would be to increase the standard loan rate to about 6 percent.

Experience with Federal credit programs demonstrates that fixed interest rates, such as the 5 percent and 2 percent rates prescribed in the REA statute, produce perverse and unintended variations in interest rate subsidies as market rates of interest vary. This results in inequities among borrowers using the program at different times and in extraordinary demands for Federal loans at times of highest market rates of interest, which are also likely to be the times of greatest inflationary pressures and need for budgetary restraint. For example, at the current cost of long-term Treasury borrowing of about 12-1/2 percent, the cost of making a typical 35-year loan at 5 percent in the amount of $3 million is the same as the cost of providing an outright grant of $1.6 million and requiring the remaining $1.4 million to be paid with interest at 12-1/2 percent. The Department, therefore, opposes interest subsidies of this nature.

The Treasury has long maintained that the benchmark interest rate for Federal lending programs should be the current cost of Treasury borrowing for a period comparable to the maturity of the loan. The essence of the argument is that while the Treasury does not enter the market to borrow a specific amount for a specific maturity to finance a loan in that amount at that maturity, it is compelled to have a comparably greater amount of debt outstanding over the life of the loan. Thus, the best measure of the cost of the loan is the current Treasury market borrowing cost for comparable maturities. Since the interest rate which section 6 would produce would bear no relation to the Treasury borrowing rate, the Department is opposed to section 6 of the bill.

Federal guarantees of tax exempts

Under existing law, the REA Administrator is authorized, but not required, to guarantee loans to rural electric and telephone borrowers and to subordinate direct loans to other financing obtained by such borrowers. Section 7 of the bill would amend existing law to require the Administrator to guarantee such loans and to subordinate REA direct loans at the request of the borrower. Such subordination would substantially increase the Government's risk. Also, since eligible borrowers include States and municipalities, the guarantee and/or subordination of these loans would result in the Federal guarantee of tax-exempt obligations.

Since 1970, Congress has enacted at least 24 statutes which preclude Federal guarantees of tax-exempts and in many cases authorize more efficient means of providing Federal credit assistance to the affected borrowers. As indicated in the list attached to my statement, these statutes affect virtually every sector of the economy -- agriculture, community facilities, education, energy, housing, rural business and economic development, and transportation.

The Administration is strongly opposed to Federal guarantees of tax-exempt obligations. Placing the credit of the United States behind a tax-exempt obligation creates a security that is superior to direct obligations issued by the U.S. Treasury and is contrary to the spirit of the Public Debt Act of 1941, which prohibits direct issuance by Federal agencies of obligations the interest on which is exempt from Federal income taxation.

Federal guarantees of tax-exempts also have adverse effects on the municipal market, because they create securities which are superior to all other tax-exempt securities issued by State and local entities. Consequently, such guarantees add to the pressures on the municipal bond market, crowd out other, less creditworthy municipal borrowers, and increase the borrowing costs of all municipal borrowers. A guarantee of a tax-exempt obligation is an inefficient means of Federal financing because the revenue loss to the Treasury greatly exceeds the interest benefits to the borrower of the tax exemption. Accordingly, the Department is opposed to section 7 of the bill.

The rural electric cooperatives have benefitted from a wide range of subsidies, including subsidized direct loans and 100 percent loan guarantees, retention of essentially tax-exempt status while taking advantage of tax incentives (e.g., Safe Harbor leasing) available to fully taxable entities, tax-exempt municipal bonds for pollution control equipment, and preferential access to low cost Federal power. No justification for the large increases in subsidies and U.S. Government risk proposed by the bill has, however, been provided. We, therefore, strongly urge the Committee to reject this legislation.

It is difficult to understand why costly legislation such as S. 1300 should be considered at this time when the Congress and the Administration have attached such high priority to reducing the Federal budget deficit.

The Department of Agriculture has drafted legislation, the main provisions of which would:

- place REA activities on budget;
- raise the REA lending rate equal to the Treasury's

cost of money; and

- require all borrowers to pay user fees to cover administrative costs of the loan.

Accordingly, we recommend prompt action on the Department of Agriculture proposal.

That concludes my prepared statement, Madam Chairman. I will be happy to respond to your questions.

Testimony

of

William A. Niskanen, Member
Council of Economic Advisers

S. 1300: AN INEFFICIENT AND INEQUITABLE WAY TO HELP RURAL RESIDENTS

Thank you, Senator Hawkins. I welcome this opportunity to give the views of the Council of Economic Advisers on increased subsidies to rural electric and telephone systems. First, I will establish that the original justifications for such subsidies are not relevant today. Second, I will show how the interest subsidies are a wasteful way of helping rural households. Third, I will show how the subsidies are inequitable. Finally, I will demonstrate that the subsidies to rural electric and telephone coops are much larger than the investment incentives available to investor-owned utilities.

The Original Rationale

The original purpose of the 1936 Act was to bring electric and telephone service to farms and rural areas. This objective has long been achieved. Today, about 95 percent of households in such areas have telephone service. The percent of farmers receiving central station electricity increased from 12 percent in 1935 to 99 percent in 1981. Although the number of consumers served by the electric cooperatives increased by 50 percent since 1970, the percentage of U.S. farms served increased by only 0.3 percent. During this period, the REA commitments for power generation and wholesale distribution facilities increased from 22 percent to 83 percent of the total commitments. In short, most new consumers served by the REA have been rural and suburban households other than farmers, while most new commitments are not to provide retail distribution, but to produce power. The REA has clearly moved beyond its original mission.

Also, when the original legislation was passed, it was widely believed that rural areas were insulated from urban financial markets. There is very little justification for that view today. While some pockets of monopoly banking may still exist, they are rare. Rural and urban financial markets are extremely well integrated today. Branch banking and correspondent banking offer substantial access to major financial centers, as does electronic fund transfer. The degree of integration and therefore competition in financial markets will only increase as financial deregulation proceeds. It is therefore safe to say that if investments in any rural electrification projects are viable, funds will be forthcoming from the private sector to support such investments.

Another justification for REA at the time was that farm families' incomes were much lower than those of nonfarm families. This justification no longer carries much force because the two have converged in recent years. In 1982, for example, average pretax income for farm families was $25,618 compared to an average of $27,391 for all families. And this overstates the after-tax difference because of the preferential tax treatment of farm income.

Maybe now is the time to declare victory and question whether increased subsidies serve an important public purpose.

The Subsidy is Wasteful

Even if increased government aid to rural households were appropriate, a subsidy of interest rates for electric power projects would be a wasteful way of granting such aid. The reason is that such a subsidy distorts choices made by electric power producers and by electric power consumers.

First, producers. Subsidize something and you'll cause more of it to be produced. This is just as true for capital as for anything else. The artificially low interest rate that REA borrowers pay induces them to overinvest in capital-intensive methods of producing power. As a result of this interest subsidy, REA borrowers have an incentive to produce higher cost electricity than otherwise. It is not higher cost to them of course. But the net cost to the economy is higher. This overinvestment can take many forms. Even though it may be less costly to buy electricity from existing utilities than to generate it, REA coops have an artificial incentive to generate electricity themselves. According to an Agriculture Department, power generation by REA borrowers has increased from 28.3 percent of electricity used by REA distribution to 42 percent since the Rural Electrification Act amendments of 1973.

Second, consumers. Even though electricity distributors waste some of the subsidy by using overly capital intensive production techniques, they are still able to charge a lower price to consumers than if they were not subsidized. This artificially lower price causes consumers to use electricity wastefully. For example, they use electricity for heating or cooking instead of, say, oil or natural gas, because they don't pay the full cost of the electricity. A study done by the National Economic Research Associates concluded that underpricing of electricity by cooperatives leads members of cooperatives to overuse electricity by about 4 percent.

In short, the interest subsidy makes electricity production too capital intensive and induces consumers to waste electricity. Thus it causes both wasteful production and wasteful consumption.

The Subsidy is Inequitable

Even though the interest subsidy was originally intended for rural residents, it often goes to suburban residents, as the inspector general of the Agriculture Department found in an audit. Moreover, because the subsidy is granted without regard to beneficiaries' income, it often goes to high income families. The inspector general found one example of a cooperative serving a clientele in a suburban area whose median income was over 20 percent higher than the national median.

Even independent of income considerations, the subsidy is inequitable. It forces taxpayers to subsidize the electricity consumption of some of their fellow citizens even while these same taxpayers must pay higher prices for their own electricity.

The Subsidy to Coops is Larger than the Investment Incentives Available to Investor-Owned Utilities

There has been a great deal of controversy about whether the subsidies to coops are indeed larger than the investment incentives available to investor-owned utilities. Those who argue that the subsidies to coops are smaller point to the investment tax credit, accelerated depreciation, and a number of other provisions of the tax code that reduce the tax bite on investments in utilities. This controversy can be easily resolved.

Two careful studies, one by the National Economic Research Associates and the other by the Congressional Research Service, have concluded that the subsidies to coops are much larger than those to investor-owned utilities. But no evidence at all is necessary to resolve this issue. All we require is an understanding of the tax code. Coops do not pay federal taxes on income derived from electric power sales, while investor-owned utilities do pay taxes on such income. Because the investment tax credit and accelerated depreciation do not reduce the utility's tax liability below zero, the best an investor-owned utility can do is to pay no taxes. In such a rare case, the investor-owned utility would be on a par tax-wise with a coop. But the investor-owned utilities would still have to pay market interest rates for capital while the coop would pay much lower interest rates. Therefore, even if the utility manages to reduce its tax liability to zero, which is the best it can do, it will still pay a higher cost of capital than the coop. Finally, if it were true that investor-owned utilities were advantaged relative to coops, then we would expect coops to drop their tax-exempt status and federally subsidized loans and become taxable entities. They are not doing so.

Conclusion

In conclusion, interest subsidies to REA coops are an inefficient means to assist rural households. These subsidies bias the choice of technologies for producing power and the choice of means to provide heat, cooking, etc. to homes. These subsidies are not well targeted to rural residents or low-income households. They misallocate capital between the coops and the investor-owned utilities. The conditions that originally invited these subsidies are substantially changed today. Increasing existing subsidies, as called for under S. 1300, is not sound economics. A better alternative to S. 1300 is to make adjustments to the program to put the fund on a sound basis by increasing interest rates and by encouraging borrowers to increase their reliance on private sector credit.

(The following material was furnished by Mr. Penner of the Congressional Budget Office.)

April 12, 1984

CONGRESSIONAL BUDGET OFFICE

ANALYSIS OF THE BUDGET IMPACT OF S. 1300, THE RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND SELF-SUFFICIENCY ACT OF 1983

S. 1300 would amend the Rural Electrification Act of 1936, as amended, for the purpose of improving the financial condition of two off-budget revolving funds administered by the Rural Electrification Administration (REA): the Rural Electric and Telephone Revolving Fund (RETRF), and the Rural Telephone Bank (RTB). It would also expand the forms of assistance to electric and telephone cooperatives under these REA programs.

For the purposes of this analysis, the Congressional Budget Office assumes that the bill will be enacted by June 1984. It is assumed that obligations of the RETRF will continue to be funded by principal repayments, interest income, and from the sale of loan assets to the Federal Financing Bank (FFB) in the form of certificates of beneficial ownership (CBOs). The level of loans made and guaranteed by the RETRF is assumed to be consistent with the minimum levels specified by the Congress for fiscal year 1984, as adjusted for inflation in future years. The inflation and interest rate assumptions used in this analysis are based on the assumptions in the baseline projections for fiscal year 1985. These estimates reflect the impact of the bill for both the electric and telephone programs, relative to current law.

BASE CASE ASSUMPTIONS

Under current law, the REA is authorized to make direct loans to the extent of the assets available in the RETRF. When the fund was established in 1973, the net capital provided by the Congress consisted of the interest income from the $7.9 billion in outstanding loans to cooperatives. The 1973 Act authorized the REA to sell the fund's assets to obtain funding for new loans, but in selling the assets, the fund incurs a corresponding obligation to repay the principal and to pay interest on the notes (CBOs). Thus, the REA's capacity to make loans is ultimately determined by the excess of interest earned on past and future loans over any interest costs.

At present, there is a structural mismatch between the RETRF's operating costs and its long-term assets. The fund is making about $1.1 billion in loans each year that bear interest of no more than 5 percent, while about 40 percent of these loans are financed by selling assets that bear interest at much higher rates. (The current average is 11.4 percent.) The Congressional Budget Office estimates that the interest losses on the $3.5 billion in obligations financed by CBOs over the past 10 years will cost the fund about $8 billion over the life of these loans. If the fund continues to lend over $1.1 billion a year at 5 percent interest, and incurs further losses in doing so, this mismatch eventually could lead to insolvency. If that occurs, the fund would default on some of its outstanding obligations to either the Treasury or the FFB. The Congressional Budget Office assumes that, under current law, REA would act to prevent such a default by reducing lending by the amount needed to ensure that the fund's resources will be sufficient to cover its obligations.

The timing and magnitude of lending reductions will depend on the extent of future losses. Under the baseline interest rate assumptions (11.4 percent for long-term Treasury debt in 1985, declining to 10.6 percent in 1989 and thereafter), the RETRF's asset portfolio would be exhausted by the year 2002 unless lending levels are reduced. Thus, for the base case, the CBO estimates that the REA would need to reduce loan disbursements beginning by 1990 in order to ensure that resources will be sufficient to cover the outstanding obligations. If lending levels are reduced earlier or interest losses are lower than assumed in the base case, the reduction in lending would occur later or be less severe.

The Congressional Budget Office estimates that under current law, receipts to the RETRF will exceed new obligations over the 1985-2010 period, because of this anticipated decline in lending activity. Income from borrowers would be used to repay the RETRF's obligations to the FFB and the Treasury instead of being reloaned to cooperatives. The following table presents the budgetary effects of the RETRF assumed under current law through the year 2010.

BUDGET IMPACT OF RETRF UNDER CURRENT LAW
(by fiscal years, in billions of dollars)

	Total 1985-1990	Total 1991-2000	Total 2001-2010
Effect on the Unified Budget (Treasury interest receipts)			
Estimated Budget Authority	-4.3	-8.6	-6.9
Estimated Outlays	-4.3	-8.6	-6.9
Off-Budget Effect (REA and FFB)			
Estimated Budget Authority	4.8	-1.4	1.1
Estimated Outlays	4.8	-3.7	-4.8
Net Outlays (On- and Off-Budget)	0.5	-12.3	-11.7

SUMMARY OF S. 1300

Through the provisions of Sections 4 and 5, the bill would provide additional resources to the RETRF by reducing its obligations to the Treasury and the FFB. The interest rate formula in Section 6 would increase interest income to the fund from borrowers. The resources provided by S. 1300 would enable the REA to maintain current lending levels (as adjusted for inflation) over the 1985 through 2010 period.

Relative to current law, and under the economic assumptions used in this analysis, enactment of S. 1300 would increase federal outlays by an estimated $10.4 billion over the fiscal years 1985 through 2010. Approximately $6.4 billion of this total is attributable to Section 4, which repeals the RETRF's obligation to repay the $7.9 billion owed to the Treasury. This provision increases outlays because the resources that would be retained by the fund to repay the Treasury under current law would be used instead to make additional loans to borrowers. Section 5, which reduces the fund's interest obligations to the FFB, would increase outlays by about $1.3 billion over this period, for the same reason. Finally, outlays would increase by another $2.7 billion despite the increase in interest income provided by Section 6, because the additional outlays resulting from maintaining current lending levels would not be fully offset by the estimated increase in income from borrowers. These effects are summarized in the following table.

BUDGET IMPACT OF S. 1300 (by fiscal years, in billions of dollars)

	Total 1985-1990	Total 1991-2000	Total 2001-2010
Effect on the Unified Budget (Treasury interest receipts)			
Estimated Budget Authority	0.3	-3.9	-18.7
Estimated Outlays	0.3	-3.9	-18.7
Off-Budget Effect (REA and FFB)			
Estimated Budget Authority	-0.4	10.5	16.5
Estimated Outlays	-0.4	12.7	20.4
Net Outlays (On- and Off-Budget)	-0.1	8.8	1.7

Three other provisions in the bill could significantly increase outlays if current administrative policies change. Section 6 expands the eligibility criteria for special rate loans, and directs the Administrator to request appropriations to cover the related interest losses. No costs would be incurred if the REA continues its current policy of making all loans at standard rates. However, if the REA were to make 15 percent of the loans at the special rate, the cost to the government would total $2.5 billion over the 1985-2010 period. Likewise, the costs of Section 7 depend on the willingness of the FFB to refinance certain REA-guaranteed loans without penalty. If the FFB were to allow eligible borrowers to refinance, the loss of interest and penalty payments to the government could total about $0.1 billion between 1985 and 2010. Finally, Section 7 also requires the Administrator to accommodate or subordinate the government's security on certain loans made or guaranteed by REA. The budgetary effects of these provisions cannot be estimated accurately, because of the uncertainty regarding the Administrator's determinations and the risk of defaults. The volume of loans outstanding potentially subject to lien accomodation or subordination totalled $29.2 billion by the end of fiscal year 1982. Other provisions of the bill are not expected to have a significant budget impact.

SECTION-BY-SECTION ANALYSIS

Section 4 converts the RETRF's obligation to repay the $7.9 billion owed to the Treasury from a liability of the fund to equity capital. Under current law, $6.2 billion of this amount will be due by 2010, with the first note payable in fiscal year 1993. The REA would be expected to finance the Treasury payments primarily with receipts from borrowers, supplemented by the sale of assets to the FFB.

Forgiving the RETRF's liability for the $7.9 billion would increase the resources available for loans to borrowers in this period. It is assumed that the resources that would have been applied to the Treasury payments would be used for loans to electric and telephone cooperatives. Thus, loan levels would be higher--and the reduction in outlays lower--than expected under current law. The net effect of these transactions is an estimated $6.4 billion increase in outlays over the 1984 through 2010 period relative to current law. The following table shows the impact of Section 4, both on- and off-budget, for those years.

BUDGET IMPACT OF SECTION 4 (by fiscal years, in billions of dollars)

	Total 1985-1990	Total 1991-2000	Total 2001-2010
Effect on the Unified Budget (Treasury interest receipts)			
Estimated Budget Authority	---	-2.8	-9.5
Estimated Outlays	---	-2.8	-9.5
Off-Budget Effect (REA and FFB)			
Estimated Budget Authority	*	5.7	6.8
Estimated Outlays	*	8.0	10.7
Net Outlays (On- and Off-Budget)	*	5.2	1.2

* Less than $50 million.

If interest rates in the long term are higher than assumed, these budget effects would occur sooner. Lower interest rates would have the opposite effect.

Section 5 authorizes the REA Administrator to repurchase CBOs from the FFB, without penalty, whenever the interest rate on the CBO exceeds the current rate for similar issues by 100 basis points. These CBOs have 30-year terms and bear interest at the Treasury rate plus one-eighth of one percent.

Under current law, such repurchases would occur only under terms agreeable to the FFB. Although there are few precedents, it appears that the FFB would require the REA to pay a premium to compensate for the loss of future interest income. Therefore, this analysis assumes that REA would not repurchase CBOs under current law.

Because this section permits such repurchases without penalty, it is assumed that REA would repurchase all eligible CBOs if the bill is enacted. This would have the effect of reducing the interest rate REA pays to the FFB on its CBO. However, the interest rate paid by the FFB on its Treasury borrowings would not be affected by the repurchases. Because the FFB's interest income from the repurchased CBOs would be less that its corresponding interest expenditures, the FFB surplus would be diminished, and its annual surplus payment to the Treasury would be reduced. If the FFB surplus is not large enough to cover these losses, Congressional action would be needed to maintain the viability of the FFB.

The budgetary effects of Section 5 are similar to those for Section 4. Under the assumptions used in this analysis, the resources of the RETRF would not be sufficient to pay the interest owed to the FFB and maintain lending at current levels. As in Section 4, it is assumed that the Administrator would reduce loan disbursements to ensure payment of these obligations under current law, and that this reduction in lending would lower federal outlays over the 1984 through 2010 period. By reducing the REA's interest obligations to the FFB, Section 5 would increase the resources available for loans to cooperatives. This would have the effect of increasing outlays by an estimated $1.3 billion over fiscal years 1985 through 2010, relative to current law. The interest loss to the FFB is estimated to total $0.6 billion over that period. The following table summarizes the budgetary effects of Section 5 through the year 2010.

BUDGET IMPACT OF SECTION 5 (by fiscal years, in billions of dollars)

	Total 1985-1990	Total 1991-2000	Total 2001-2010
Effect on the Unified Budget (Treasury receipts)			
Estimated Budget Authority	0.2	*	-1.5
Estimated Outlays	0.2	*	-1.5
Off-Budget Effect (FFB)			
Estimated Budget Authority	-0.2	1.0	1.7
Estimated Outlays	-0.2	1.0	1.7
Net Outlays (On- and Off-Budget)	---	1.0	0.2

* Less than $50 million.

If interest rates in the long term are higher than the assumed 10.6 percent, these budget effects would be reduced. Lower interest rates would have the opposite effect.

Section 6 modifies the interest rate for REA's direct loans. These rates are fixed by law at 5 percent for "standard rate" loans, and at 2 percent for "special rate" loans. In 1981, Congress limited the eligibility for special rate loans to borrowers experiencing extreme financial hardship, or substantial utility rate disparities. Virtually all loans made since these provisions took effect bear interest at 5 percent.

Section 6 replaces these fixed rates with variable interest rates to be determined by the Administrator. It also expands the eligibility for special rate loans by adding criteria on the income and density characteristics of the service area. The bill's interest rate formula specifies that the standard rate shall be sufficient to produce interest income equal to the anticipated interest cost of REA's obligations incurred in a given period, but no less than 5 percent. The interest rate for special rate loans is to be no more than one-half of the standard rate, but no less than 2 percent. Section 6 directs the Secretary of Agriculture to request appropriations to cover the cost to the fund of loans made at less than the standard rate.

For the purposes of this estimate, it is assumed that the regulations implementing the variable interest rate would go into effect by the beginning of fiscal year 1985. Using the baseline economic assumptions, and assuming the enactment of Sections 4 and 5, it is estimated that the interest rate resulting from the formula for standard rate loans would average less than 8 percent over the 1985 through 2010 period.

Under these assumptions, the additional income resulting from the interest rate changes in Section 6 would enable the RETRF to maintain current lending levels (as adjusted for inflation) over the 1985-2010 period. The fund's interest expenses would exceed the interest income, however, beginning around the year 2005. As a result, the REA would need to sell an additional $0.5 billion in assets to the FFB by the year 2010 to cover these interest losses. The volume of lending made possible by the increased interest receipts and by additional asset sales would exceed the additional income by about $2.7 billion over this period. Thus, after reflecting the effects of Sections 4 and 5, Section 6 would increase outlays by an estimated $2.7 billion. The following table summarizes these budgetary impacts over the fiscal years 1985 through 2010.

BUDGET IMPACT OF SECTION 6 (by fiscal years, in billions of dollars)

	Total 1985-1990	Total 1991-2000	Total 2001-2010
Effect on the Unified Budget (Treasury interest receipts)			
Estimated Budget Authority	0.1	-1.1	-7.7
Estimated Outlays	0.1	-1.1	-7.7
Off-Budget Effect (REA and FFB)			
Estimated Budget Authority	-0.3	3.7	8.0
Estimated Outlays	-0.3	3.7	8.0
Net Outlays (On- and Off-Budget)	-0.2	2.6	0.3

The impact of the expanded eligibility criteria for special rate loans will depend on the Administrator's use of this authority. For example, if the REA continues its current policy of making virtually all loans at the standard rate, no costs would be incurred by the fund for such loans. Alternatively, if 15 percent of the borrowers qualify for and receive special rate loans, the Administrator would be expected to request appropriations totaling about $2.5 billion from 1986 through 2010, to cover losses to the fund.

Section 7(a) entitles electric and telephone borrowers to REA guarantees and the associated loans from the FFB, subject only to limitations set by the Congress. Under current law, the Administrator's authority to guarantee loans is discretionary rather than mandatory. Enactment of this provision would not significantly affect the REA's contingent liability or FFB outlays, because virtually all such loans are guaranteed in any event.

Section 7(a) also requires the Administrator to subordinate or accommodate the government's security on loans made or guaranteed by the REA upon the request of the borrower, if the Administrator determines that the borrower's revenues will be sufficient to repay its indebtedness. Under current law, the Administrator's authority to subordinate or accommodate government liens or mortgages is discretionary, rather than mandatory. The REA presently accommodates liens, primarily for concurrent financing for distributing companies. In these cases, the government shares a security interest with other lenders on a proportionate basis. There are fewer cases of lien subordination, because this would give the other lenders, rather than the government, first claim on the loan collateral in the event of any losses or defaults.

Enactment of these provisions would dilute the government's security on loans made or guaranteed by REA, and increase the risk of loss to the government in the event of default. The budgetary effects of such lien accommodations or subordinations cannot be estimated accurately, because of the uncertainty regarding the Administrator's determinations and the risk of defaults. However, the volume of outstanding loans potentially subject to lien accommodation or subordination totalled $29.2 billion by the end of fiscal year 1982.

Section 7(c). Virtually all of the loans guaranteed by the REA have been made by the FFB. The existing FFB notes do not allow prepayments until after the 12th year after the date of the advance. Borrowers that elect to prepay the note after that time are obligated to pay a premium based on formulas specified in the notes. Because the first notes were issued in 1975, none of the notes could be prepaid prior to 1988 under current law. For the purpose of this analysis, it is assumed that under current law, notes would be prepaid whenever the required premium would be less than the net present value of the interest savings.

This provision authorizes lenders, including the FFB, to refinance REA-guaranteed loans, without penalty, if a loan's remaining maturity exceeds seven years and the interest rate exceeds the current rate by more than 100 basis points. For this estimate, it is assumed that the FFB would not exercise this authority. However, if the FFB allows borrowers to refinance all of the eligible notes, enactment of this provision would result in a loss of interest income and penalty payments to the FFB, and greater unified budget outlays. Under the economic assumptions used in this analysis, these losses would total $0.1 billion over the fiscal years 1984 through 2010--but would occur only if the FFB chooses to exercise the authority provided in the bill.

Other Provisions. S. 1300 directs the REA to issue rules and regulations implementing the new interest rate formulas and the line accommodation and subordination policies. The bill also requires the creation of separate accounts for the electric and telephone revolving funds. These provisions are not expected to significantly increase REA's administrative expenses.

Section 8 of this bill specifies that if the minimum loan level for electrification borrowers is less than $1.0 billion in any year, the required proportion of nonfederal financing shall be fixed at the ratio in effect for 1983. This provision only affects the amount of funding provided by nonfederal sources, and is not expected to have any impact on the federal budget.

S. 1300 includes a number of provisions affecting the Rural Telephone Bank (RTB), a supplemental source of financing for rural telephone companies, operated by the REA. It removes the current 1991 time limit on U.S. government purchases of Class A stock in the bank. It also removes certain procedural and eligibility barriers to borrowing from the RTB. Although the bill increases the universe of borrowers eligible for RTB assistance, these provisions are not expected to affect the federal budget, either on- or off-budget, unless the Congress changes its annual limitation on direct lending by the bank.

COMPARISON WITH PREVIOUS CBO ESTIMATE

On October 14, 1983, the Congressional Budget Office prepared an analysis of S. 1300 for the Subcommittee on Agricultural Credit and Rural Electrification of the Senate Committee on Agriculture, Nutrition and Forestry. The differences between that estimate and this analysis are due to the differences in the economic assumptions. The October 1983 estimate was based on the inflation and interest rate assumptions in the first concurrent budget resolution for fiscal year 1984. The long-term interest rate and inflation assumptions in the 1984 resolution were about 6 percent and 4 percent, respectively. As indicated in that estimate, the net budgetary effects of the bill would not be expected to occur until the distant future, because the fund's assets would be sufficient to finance its obligations through the year 2010 under those economic conditions. However, the updated interest rate assumptions used in this analysis--long-term Treasury borrowing rates beginning at 11.4 percent and declining to 10.6 percent--produce a signficantly different financial outlook for the fund. The estimated budgetary effects of the bill change accordingly.

STATEMENT OF JOHN LUKE, ASSOCIATE DIRECTOR, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Madam Chairman and Members of the Subcommittee:

We are here today to discuss our ongoing review of the integrity of the Rural Electrification and Telephone Revolving Fund, which is administered by the Rural Electrification Administration (REA). As a part of our review, you requested that we look into:

--the size of subsidies being provided to investor-owned utilities (IOU's), public utilities, and rural electric cooperatives (REC's),

--the effect of these subsidies on utility rates,

--the extent to which subsidies on REA loans have resulted in an unfunded liability in the revolving fund,

--the impact of Senate bill S. 1300 on balancing the fund, and

--the options or other matters the Congress should consider in its deliberation of S. 1300.

In summary, we found that REC's receive loan subsidies that are 2.4 times greater than the tax benefits received by IOU's. These loan subsidies help to reduce REC electric rates by about 7 percent whereas the tax benefits IOU's receive reduce electric rates by only about 3 percent. REA loan subsidies have not yet produced an unfunded liability in the revolving fund but such a liability will begin to accrue in the fund in about 3.5 years at present loan and subsidy levels.

S. 1300 would attempt to make the fund self-sufficient by changing loan interest rates, capitalizing the funds' Treasury debts, and authorizing the fund to refinance its debts with the Federal Financing Bank when interest rates are falling. But these actions will not be adequate under present conditions to make the fund self-sufficient.

More importantly, the interest rate provisions in S. 1300 would continue federal subsidies to REC's regardless of financial need and/or the rural/urban constituency of the consumers they serve. Rather than set loan interest rates to make the fund self-sufficient, the Congress should reexamine the program's objectives and the criteria being used to determine the level of assistance needed and the intended beneficiaries. Any subsidies resulting from this could be appropriated. This would provide a better perspective of the cost of REA's programs and ensure the continued operation of the revolving fund.

The permanent capitalization of the fund's $7.9 billion in debts to the Treasury is questionable considering that the fund is now capable of repaying this debt. Further, this action would take place outside the budget/appropriation process and as such, it represents a form of "backdoor" financing. If this action is truly needed, then the Congress should consider using the budget/appropriation process to accomplish this.

Regardless of whether appropriations are used to capitalize the fund's Treasury debts or fund loan subsidies, the Congress should consider bringing the activities of the revolving fund back on-budget.

Besides allowing the fund to refinance its debts with the Federal Financing Bank, S. 1300 also would allow REC's to refinance, when interest rates are falling, REA guaranteed loans financed by the Bank. Because only downward adjustments would be made in interest rates under these provisions, this one-sided approach would shift some of the risk of financing to the government and possibly result in unnecessary losses. To preclude this, the Congress may wish to provide for an adjustable or variable loan interest rate.

BACKGROUND

The Rural Electrification and Telephone Revolving Fund was established in 1973 to facilitate the financing of REA loans to REC's and telephone companies or cooperatives serving rural areas. When the fund was established, all existing REA loans were placed in the fund, and the principal and interest collections on these loans were to be used to fund new loans. Because the loans placed into the fund had been financed from borrowings from the Department of the Treasury, the fund was required to repay these Treasury debts, which total $7.9 billion. These debts are scheduled for repayment between 1993 and 2016. However, the fund was relieved by law of having to pay any interest on these debts when it was established.

When the income to the fund is not large enough to meet loan advances on other obligations, the fund sells Certificates of Beneficial Ownership (CBO's) in the loans made and held by the fund. To date, all CBO's have been sold to the Federal Financing Bank (FFB), which is an agency within the Department of the Treasury. The FFB obtains its funds from the Treasury, which in turn sells notes and bonds on the open market. The fund pays interest on CBO's based on the cost the Treasury incurs in raising funds, hereafter referred to as the government's cost of borrowing, plus one-eighth of 1 percent.

For years, the fund has been borrowing from the FFB (selling them CBO's) at interest rates substantially higher than the interest rates charged on REA loans financed from the fund. As a result, REA now estimates that the fund's interest expenses will exceed interest income by about 1986 and that appropriations will be needed by 2002 if the fund is to continue to operate.

REA loans made from the fund generally bear interest at 5 percent; but the REA Administrator can also make loans at a special rate of 2 percent. These low 5- and 2-percent interest rate loans have been used generally to finance electric distribution facilities and telephone services. REA also guarantees loans made by third parties and the fund is responsible for any losses arising from these guarantees. Guaranteed loans bear interest at a rate agreed to by the borrower and lender. Most guaranteed loans, about 86 percent, have been made by the FFB at rates equal to the government's cost of borrowing plus one-eighth of 1 percent and most have been used to finance electric generation and transmission facilities. REA's direct and guaranteed loans are repayable with maturities up to 35 years.

Senate bill S. 1300 would attempt to balance the fund, that is, make it self sufficient by

- --changing the basis for setting interest rates on REA loans, and
- --reducing the fund's future cash payments by permanently capitalizing the fund's $7.9 billion Treasury debt and authorizing the fund to refinance at reduced interest rates its borrowings from the Federal Financing Bank.

FEDERAL SUBSIDIES TO ELECTRIC UTILITIES

IOU's, public utilities, and REC's all receive sizeable subsidies from the federal government. IOU's receive sizeable tax benefits, primarily in the form of tax deferral through accelerated depreciation and the investment tax credit, which offsets part or all of the income tax imposed on profit-making private corporations. IOU's also benefit from the deferral of federal income taxes on dividends that are reinvested in the IOU in the form of common stock. Other corporations besides IOU's are also eligible for these tax benefits, with the exception of dividend reinvestments. However, according to a November 29, 1982, Congressional Research Service report,[1] these tax benefits have rendered very large benefits to IOU's because of their extreme capital intensity; benefits that were enhanced through recent tax changes aimed at further shortening depreciation periods for public utility property. Public utilities are tax-exempt and are able to raise capital through the sale of bonds on which the interest income is tax exempt. REC's generally are also tax-exempt, in addition, they receive direct low-interest rate loans from REA.

Exhibit A shows our estimate of the federal income taxes that would be lost today in financing $850 million in capital expenditures through (1) the tax benefits IOU's would receive from investment tax credits and accelerated depreciation and (2) the issuance of tax-exempt bonds by public utilities. It compares these estimates to our estimate of the REA loan subsidies that would be provided through a comparable level of capital expenditures by REC's. We used $850 million in capital expenditures because this represents the current annual level of REA's direct loan program. Other assumptions used to prepare this exhibit are listed in appendix I.

As exhibit A shows, the subsidy cost of financing capital expenditures through REA's direct loans is now about 2.4 times the government's cost (taxes lost) in financing an equal amount of capital expenditures for IOU's. Further these direct loan subsidies enable REC's to lower the electric rates charged their consumers. We estimate that REA's 5-percent interest rate loans today work to reduce consumer electric rates by almost 7 percent. In comparison, Don Kiefer of the Congressional Research Service[2] has determined that the tax benefits provided to IOU's have reduced IOU electric rates by only about 3 percent.

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[1] Kiefer, Donald W., "Investor-Owned Electric Utilities versus Rural Electric Cooperatives: A Comparison of Tax and Financial Subsidies," Congressional Research Service, November 29, 1982.

REC's receive other benefits besides loan subsidies that help to further reduce the electric rates REC's must charge their customers but which were not considered in preparing exhibit A. As previously noted, REC's are generally exempt from paying federal income taxes. We discussed this issue in our January 1983 report to the Congress on "Legislation Needed to Improve Administration of Tax Exempt Provisions for Electric Cooperatives" (GAO/GGD-83-7, Jan. 5, 1983). Specifically, we reported on how the operations of many REC's and the environment in which they do business have changed substantially since the time they were granted tax exemption. In view of these changed conditions, we reported on how the Internal Revenue Service needed to make administrative changes to better enforce the existing tax exemption provisions. More importantly, we recommended that the Congress adopt a tax treatment which better recognizes changes in some electric cooperatives. A summary of our report is included in appendix II.

The benefits REC's derive from tax exemption together with REA loan subsidies were compared to the tax benefits IOU's receive in a November 29, 1982, Congressional Research Service report.[3] Rather than calculate the dollar amount of subsidy, this study estimated the reduction in utility rates charged to customers. The study considered this to be a more appropriate way to measure and compare subsidies because price response determines the economic effects of the subsidies. In looking at subsidies in this manner, the study concluded that in comparison to a fully taxable, nonsubsidized firm, REC's were currently receiving larger subsidies from the federal government through tax-exemption and loan subsidies than IOU's received through investment tax credits and accelerated depreciation. Further, the study indicated that this conclusion would not be so clear if loan subsidies were eliminated in which case the issue of who was receiving the greater subsidy would depend on the discount rate used in the analysis.

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[2] Kiefer, Donald W., "The Impact of the Economic Recovery Tax Act of 1981 on the Public Utility Industry," Congressional Research Service, Report No. 82-6E, January 15, 1981, App. II.

[3] See footnote 1.

Besides their tax-exemption and REA loan subsidies, REC's receive other benefits not otherwise shared by IOU's which could further reduce their electric utility rates. For example, REC's and likewise public utilities can purchase power from federal agencies on a preferential basis. REC's also do not pay any fees to cover REA's expenses in administering the electric loan program nor pay interest (rate of return) on their capital.

Before moving on to the revolving fund, we should point out that telephone companies and cooperatives also receive REA's low interest rate loans. Based on present loan levels, about $250 million annually, the amount of subsidies being provided to telephone companies and cooperatives is now about $119 million (present value) annually. In addition, REA-assisted telephone companies also benefit from the same tax benefits being provided to IOU's--investment tax credits and accelerated depreciation.

IMPACT OF SUBSIDIES ON THE REVOLVING FUND

To determine the impact of subsidies on the revolving fund, we obtained, using REA's computer model of the fund, a report on the fund's future receipts and payments assuming REA's programs were allowed to lapse at the end of fiscal year 1983. We then discounted these receipts and payments to their present value based on the government's cost of borrowing. At this point, we should point out that we have reviewed REA's computer model and believe it provides a reasonable estimate of the outcomes that can be expected based on the assumptions used. The results of our analysis, which are shown in exhibit B, provide a status report of the fund.

As exhibit B shows, the funds $8.6 billion in receipts (present value) is adequate to cover all payments, including the repayment of $7.9 billion in Treasury debt, which now has a present value of $1 billion. In fact, after all payments are made, the fund will have excess receipts of $1.6 billion (present value), which is in effect the remaining (unused) equity of the fund. Considering the net equity now in the fund, the fund has not yet incurred an unfunded liability.

Although the fund is now sound, that is it has a net equity of $1.6 billion, exhibit B shows that REA loans financed through the fund have cost the taxpayers $8.2 billion. This is because the fund's net equity is insufficient to cover the interest that the Treasury will have to absorb through the waiver of interest on the fund's $7.9 billion in Treasury debt. Based on the government's cost of borrowing when these Treasury debts were incurred, we estimated that the present value of this forgiven interest is $9.8 billion.

Based on the fund's $1.6 billion in net equity, we estimate that the fund can operate for about 3.5 more years at current funding and subsidy levels at which time the fund's net equity will be exhausted. Without some form of relief, the continued operation of REA's programs beyond 3.5 years would result in a deficit (unfunded liability) in the fund.

INTEREST RATES UNDER S. 1300

S. 1300 would eliminate the existing fixed 5 percent interest rate for REA's direct (insured) loans. Instead, under section 6(1) of the bill, the standard interest rate would be set at a rate, but not less than 5 percent, that would produce interest income equal to the amount of anticipated interest expense on the account's obligations (debt) required to be issued or sold during such period to cover loan advances and interest expenses. Under section 6(1), the account's obligations would be determined by deducting the sum of principal and interest receipts and any appropriations made pursuant to section 6(3) from the sum of loan advances and interest expense on outstanding obligations. Exhibit C illustrates how this formula would be used to set the standard rate.

According to REA, the interest rates derived from this formula will not be sufficient to balance the fund, that is make it self-sufficient, under conditions in effect today. This would be the case even if action was taken to reduce the fund's cash outlays by (1) permanently capitalizing the fund's Treasury debt as provided for in section 4 of the bill and/or (2) authorizing the fund to refinance CBO's when the rates on new CBO's dropped by at least 1 percentage point as in section 5 of the bill.

We agree with REA's assessment. REA interprets the formula the same as we do. In addition, we reviewed REA's application of this formula, including its computer program, and believe the rates REA computed provide a reasonable estimate of the rates that could be expected under the formula. The formula does not work in most situations because the interest rates derived from the formula do not generate sufficient interest income to cover interest expenses. In addition, the formula makes no provisions for retiring the fund's outstanding CBO's. As a result, the fund has to sell larger amounts of CBO's than would otherwise be necessary and eventually, the loans available for CBO sales become exhausted, making appropriations necessary.

Exhibit D shows the rates REA expects from using this formula, with and without sections 4 and 5, assuming the government's cost of borrowing (CBO interest rate) remains at about 11 percent (the rate as of June 1983).

Regardless of the growth assumption used, as exhibit D shows, appropriations would be needed as early as 2005 or as late as 2016. Consequently, the interest rates derived from the section 6(1) formula will not be adequate to ensure the self-sufficiency of the revolving fund.

Using its computer model of the fund, REA estimated that an interest rate of about 8.4 percent would be needed to balance the fund assuming

--the government's cost of borrowing remains at 11 percent,

--program lending remains at the current level of about $1.1 billion (no growth), and

--sections 4 and 5 of S. 1300 are not authorized.

In contrast, as exhibit D shows, the section 6(1) formula based on these same assumptions would result in an average interest rate of only 7.8 percent, a rate that is insufficient to balance the fund.

Besides not balancing the revolving fund, the formula rates would continue federal subsidies. This is because the formula presumes that loan receipts (those in excess of interest expenses) are assets of the fund and therefore carry a zero interest cost when they are reloaned. This presumption is recognized in the National Rural Electric Cooperative Association's January 1983 report on "Rural Electric Financing for the Future." Accordingly, the formula provides for deducting loan receipts from the sum of advances and interest expense to arrive at the accounts obligations as shown in exhibit C. However, loan receipts have a value to the government equal to the government cost of money. This is so because the reuse of these funds to make new loans deprives the government of the use of these funds; funds that the Treasury could use to reduce its borrowings. Moreover, as long as REA's loans carry rates less than the Government's cost of money, a federal subsidy will exist.

Based on the average interest rates to be paid under section 6(1) under the no growth scenario (see exhibit D), we estimate that the average federal subsidy will total $287 million, $314 million if sections 4 and 5 are also enacted, for each $1.1 billion made in new loans. Similarly, if rates were set at the 8.4 percent rate deemed necessary by REA to balance the fund, the average federal subsidy would be more in the neighborhood of $224 million for each $1.1 billion in new loans. In contrast, the federal subsidy now totals $523 million for each $1.1 billion in new loans. Consequently, subsidy cost would be reduced substantially over present levels by either enacting section 6(1) or raising rates to the level needed to balance the fund.

NEED FOR SUBSIDIES

But are subsidies needed? More importantly, what should be the appropriate level of subsidy, if any, or the REA loan interest rate? To address this issue, we call your attention to our report on the "Rural Electrication Administration Loans to Electric Distribution Systems: Policy Changes Needed" (CED-80-52, May 30, 1980).

The report points out that many rural electric distribution systems appear financially sound and able to qualify for non-REA loans at reasonable rates and terms. For example, as of December 1978, 386 of the 922 REA distribution system borrowers, or about 42 percent, had a times interest earned ratio[4] of 2.5 or more and an equity ratio[5] of 30 percent or more, levels which would generally be sufficient to obtain financing from private creditors at reasonable rates and terms. Some of these borrowers have to charge relatively high electric rates to maintain financial soundness. Others, however, have low costs and could absorb increased interest costs and still charge electric rates comparable to those charged by neighboring investor-owned utilities. For example, based on an analysis of 14 borrowers, we reported that 4 could absorb increased interest costs without making any changes in electric rates whereas the remaining 10 would have had to increase residential electric rates by no more than 8.3 percent ($3.59 per month per customer) based on projected average monthly usage. Although it appeared some borrowers could obtain all their financing from private sources without adversely affecting interest rates, the report stated that REA did not have criteria to determine which borrowers could qualify for private sector loans.

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[4] A ratio showing the number of times net income covers interest expenses.

[5] Ratio of net worth to total assets.

In response to your request, we updated this information. The results of this update are shown in exhibit E. As this exhibit shows, as of December 1981, 305 of the 921 electric distribution borrowers that reported equity levels to REA, or 33 percent, had an equity ratio of 30 percent or more and a times interest earned ratio of 2.5 or more. Further, 199 of the 305 distribution borrowers, or about 22 percent of all those reporting, had an equity ratio of 40 percent or more. The latter is important when you consider that as of December 1981, the average equity level for IOU's was 40 percent and their average times interest earned ratio was 2.3.

As exhibit E also shows, many of the financially sound REC's had electric rates that were below either the (1) National average IOU electric rate, (2) National average IOU residential electric rate, or (3) National average REC residential electric rate. I would emphasize that caution should be exercised in using this data because it does not consider regional variations.

For borrowers that do not have the financial strength to borrow from private credit sources, our report stated that REA needed to do more to encourage borrowers to become self-sufficient. Specifically, REA needs to establish minimum equity goals for borrowers, require borrowers to develop plans to achieve these goals, and in reviewing electric rate changes, ensure that rates are sufficient to meet the equity levels set forth in the plans.

In addition, the report pointed out that REA's loan making criteria does not adequately correlate the type and/or amount of subsidized loan REA will provide with the borrowers' needs. As a result, some borrowers that had high costs and high electric rates, received the same subsidy or even less than borrowers with low costs and rates. We concluded that REA needed new loan criteria to better correlate the type and amount of subsidized loan to the borrower's individual needs for assistance and we recommended that REA develop a legislative plan to revise its policies for making insured electric loans.

In addition, our report raised the issue as to whether rate comparability is an objective of the REA program. The Rural Electrification Act of 1936, as amended, does not directly set forth rate comparability with urban areas or IOU's as an objective of REA's electric programs. But we did offer evidence to show that rate comparability should be an objective of REA's electric program. In addition, we pointed out that the act's objective of providing central station electricity to rural persons, for all intents and purposes, has long been accomplished.

To date, no action has been taken on our report's recommendations.

In addition, we would like to call your attention to the Department of Agriculture, Office of Inspector General's May 20, 1983, audit report on "Loan Making Policies for Electric Distribution Cooperatives" (Audit Report No. 09613-1-CH). In that report, the Inspector General confirmed what we had found in our May 1980 report, namely that REC's were receiving REA assistance regardless of financial need. In addition, the Inspector General reported that REC's were still receiving REA assistance regardless of whether they were still serving rural areas. According to their report, REA and the Department of Agriculture's Office of General Counsel have interpreted the Rural Electrification Act and congressional directives to allow loans to REC's regardless of their financial strength or the urban/rural characteristics of their service areas. In addition, their report also stated that REA's operating procedures needed to be strengthened to ensure that loan funds are disbursed properly and used only for authorized purposes. A more detailed summary of the reports findings and recommendations is included in appendix III.

In light of the findings in these two reports, we urge the Congress in its deliberations of S. 1300 to reexamine and clarify the program's objectives as well as the criteria to be used to determine the level of assistance (subsidy) to be provided and the intended beneficiaries to accomplish the program's objectives.

REFINANCING LOANS

Section 7(4) of the bill would allow borrowers with REA guaranteed loans to refinance their loans, without penalty, when the rates paid on these loans exceed the rates for new loans by one percentage point or more. Loans would have to have a remaining term to maturity of at least 7 years to be eligible for refinancing and no loan could be refinanced more than once in any 7 year period. Similarly, section 5 would allow the fund to repurchase from the FFB, in effect refinance, its outstanding CBO's that have a remaining life of 7 years or more whenever the interest rate on these debts exceeds the rate applicable to new CBO's by 1 percentage point or more.

These sections would permit REC's and the fund to reduce their interest cost. For example, if section 5 were in effect in June 1983, the fund could have refinanced $1.9 billion in CBO's, which were initially sold to the FFB at an average interest rate of 13.1 percent, for about 11 percent. We estimated that this refinancing would save the fund about $328 million (present value) over the remaining life of these CBO's, thereby increasing the fund's capacity to operate further into the future. Additional refinancings would produce even greater savings.

Although REC's and the fund would realize savings through such refinancings, neither section 5 nor 7(4) provide for increasing interest rates when interest rates are rising. Therefore, this one-sided approach would shift some of the risk of financing to the government. This is because the government, through Treasury's public debt borrowings, is the ultimate source of funds for CBO's and REA guaranteed loans financed through the FFB. Further, as a result of this shift, the government could realize either a gain, thereby negating any savings realized through the refinancing of CBO's and REA guaranteed loans, or incur a loss. Such gains or losses are possible considering the overall short-term nature of the government's borrowings, the frequency with which these debts are refinanced relative to the refinancing of CBO's and REA guaranteed loans, and the future movement of interest rates. To preclude such gains or losses, the Congress may wish to amend sections 5 and 7(4) to provide for charging an adjustable or variable interest rate to provide for upward as well as downward adjustments in interest rates.

CAPITALIZATION OF TREASURY DEBT

As shown in exhibit B, the fund is capable of repaying its $7.9 billion in debts to the Treasury. Yet, section 4 of the bill would permanently capitalize this debt as equity in the revolving fund.

The capitalization of Treasury debt would inject the fund with additional financial resources, thereby enabling the fund to reduce its CBO sales and in turn its interest expenses. This reduction in interest expenses is similar to the reduction in interest expenses that would be made possible through the refinancing of CBO's as provided in section 5.

As shown in exhibit C, the funds interest expenses would be considered in setting loan interest rates under the formula provided in section 6(1). Therefore, this action together with section 5 would ultimately affect loan interest rates. This is illustrated in exhibit D, which shows that under the no growth scenario, loan interest rates would average 7.8 percent without sections 4 and 5 and 7.4 percent with these sections. In this scenario, loan interest rates would be reduced, thereby, resulting in larger loan subsidies.

Considering the impact of sections 4 and 5 on loan interest rates and in turn loan subsidies, the Congress may wish to consider the effects of these provisions in addressing the subsidy issue.

This injection of resources also would allow the fund to operate farther into the future before appropriations would be needed. For example, as shown in exhibit D, appropriations would be needed by 2005 under the no growth scenario and without sections 4 and 5. In contrast, the need for appropriations would be put off until 2016, a difference of 11 years, if sections 4 and 5 were put into law.

Furthermore, this capitalization of Treasury debt is analagous to appropriating $1 billion to the fund today. As shown in exhibit B, the present value of this Treasury debt is about $1 billion. However, because this action would take place outside the budget/appropriation process, we believe it represents a form of "backdoor" financing. In the past, we have objected to similar "backdoor" financing schemes because they lessen the Congress's ability to control the federal budget.

If the Congress desires to capitalize this debt, we recommend that appropriations be used to accomplish this. Appropriations have been used in the past to capitalize other funds, including the Rural Telephone Bank administered by REA. Further, this action would be consistent with our recommendation[6] to use appropriations to retire Amtrak's debt to the government.

As an alternative, the Congress should consider making appropriations to cover any and all loan subsidies that might result from its actions in establishing new REA loan interest rates. If this were done, the fund would be able to repay its Treasury debts as they become due. In addition, the fund's net equity as shown in exhibit B could eventually be returned to the Treasury to defray the interest cost that the Treasury has had to absorb through the waiver of interest on this debt. More importantly, by appropriating all loan subsidies, we believe the Congress would be provided with a better perspective of the cost of REA's loan program.

The appropriation of loan subsidies also would be consistent with section 6(3) of the bill which would require REA to request an appropriation each year to replenish the fund for subsidies made during the preceding fiscal year on loans made at less than the standard interest rate as provided in section 6(1) of the bill. In this respect, section 6(3) could be amended to cover all loan subsidies. In addition, this provision could be further amended to provide for making appropriations on a prospective rather than retroactive basis, that is the amount appropriated should be adequated to cover the full subsidy cost on all loans or advances to be made during the fiscal year in question. If this were done, REA could actually use its appropriations to buy down the interest rate on CBO sales to match whatever interest rate the Congress ultimately decides is appropriate for REA loans.

The amount of funds that would have to be appropriated to fund subsidies, that is to buy down the loan interest rate, will depend on the REA loan interest rate, the rate being charged on CBO's, and the amount of loan advances to be financed in any fiscal year. Exhibit F contains an example of a matrix similar to one that might be used to determine the appropriations needed to buy-down loan interest rates.

Besides using appropriations to capitalize Treasury debt or fund all or part of REA loan subsidies, we recommend that the Congress bring the revolving fund back on-budget. When the revolving fund was established in 1973, its activities were placed off-budget. We have consistently opposed off-budget programs, including this one,[7] because such programs do not have to compete for resources within the same decision framework applied to on-budget programs, although such programs may be equally worthwhile.

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[6] This recommendation was made in our March 28, 1980, report on "Alternatives for Eliminating Amtrak's Debt to the Government" (PAD-80-45).

Madam Chairman, this completes my prepared statement and I would be pleased to answer any questions at this time.

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[7] The off-budget status of REA loans was discussed in our November 28, 1980, report on "Financing Rural Electric Generating Facilities: A Large and Growing Activity" (CED-81-14).

EXHIBIT A EXHIBIT A

GOVERNMENT'S COST TO FINANCE $850 MILLION IN CAPITAL EXPENDITURES

(Life Cycle Cost in Present Value Terms)

	Government's Cost (in million)
IOU's	
Federal income taxes lost from:	
Investment tax credit	$ 85
Accelerated versus straight line depreciation	84
Total	$169
Public utilities	
Federal income taxes lost from sale of tax-exempt bonds	$279
REC's	
Subsidy from REA direct loans	$404*

*Government's cost to finance REC's is 2.4 times the cost to finance IOU's and 1.4 times the cost to finance PU's.

EXHIBIT B EXHIBIT B

CASH FLOW STATUS OF REVOLVING FUND

	Amount in Current dollars (note a)	Amount in Present value (note b)
	---in billions---	
Cash Receipts:		
Loan Repayments	$25.9	$8.3
CBO sales for unadvanced loans	.3	.3
Total	26.2	8.6
Cash Payments:		
Loan Advances	2.7	2.1
Interest on CBO's	11.3	3.7
Repurchase of CBO's	3.6	.2
Repayment of Treasury Debt	7.9	1.0
Total	25.5	7.0
Net Receipts or Equity of Fund	.7	1.6
Less: Interest Waived on Treasury Debt	12.6	9.8
Cost of REA Programs to Taxpayer	$11.9	$8.2

[a] Current dollars in the year received or paid.

[b] Assuming a 11 percent discount factor, which is equivalent to the Government's current long term borrowing costs as of June 1983.

EXHIBIT C EXHIBIT C

Standard Rate Formula

Loan advances	+	Interest expense	=	Sum of advances and interest expense	-	Loan receipts	-	Appro- priations	=	Accounts obligations
$ 1,100		$400		$1,500		$900		- 0 -		$600

Computation of Standard Rate

Accounts obligations	$600
Interest Rate on CBO's (11 percent)	.11
Interest expense on accounts obligations	$ 66
Divided by loan advances	$1,100
Standard Rate	.06 or 6 percent

EXPECTED INTEREST RATES UNDER SECTION 6(1) (note a)

	Without Sections 4 and 5	With Section 4 and 5 (note b)
Assuming no growth in program levels (c):		
Low	5.0%	5.0%
High	12.4%	11.2%
Average (d)	7.8%	7.4%
Year Appropriations First Needed	2005	2016
Assuming 6 percent growth in program levels:		
Low	5.0%	5.0%
High	11.2%	10.6%
Average (c)	9.7%	9.6%
Year Appropriations Needed	2005	2014

a/Based on a CBO interest rate of 11 percent, which was the government's cost of long term borrowing as of June 1983.

b/ Does not consider the full impact of section 5 considering the uncertainty of predicting the extent to which interest rates on new CBO's will decline in the future.

c/Program lending remains at the current level of about $1.1 billion.

d/As computed by GAO.

EXHIBIT E

FINANCIAL STATUS OF REA ELECTRIC DISTRIBUTION BORROWERS AS OF DECEMBER 1981

				2.5 TIER					
				30% Equity Ratio			40 % Equity Ratio		
		Percent of			Percent of			Percent of	
	Total Number	Column Total	Line Total	Total Number	Column Total	Line Total	Total Number	Column Number	Line Total
Distribution Borrowers: Reporting Equity Ratio's:	921	100	100	305	100	33.1	199	100	21.6
With Electric Rates Lower Than:									
Avg. IOU Electric Rate:									
Total lower	447	48.5	100	193	63.3	43.2	126	63.3	28.2
Up to 10% less	158	17.2	100	62	20.3	39.2	41	20.6	25.9
11% to 20% less	168	18.2	100	88	28.9	52.4	64	32.2	38.1
21% or more less	121	13.1	100	43	14.1	35.5	21	10.5	17.4
Avg. IOU Residential Rate:									
Total lower	681	73.9	100	257	84.3	37.7	174	87.4	25.6
Up to 10% less	200	21.7	100	55	18.0	27.5	35	17.6	17.5
21% to 20% less	201	21.8	100	70	23.0	34.8	44	22.1	21.9
21% or more less	280	30.4	100	132	43.3	47.1	95	47.7	33.9
Avg. REC Residential Rate:									
Total lower	414	45.0	100	182	59.7	44.0	126	63.3	30.4
Up to 10% less	162	17.6	100	62	20.3	38.3	39	19.6	24.1
11% to 20% less	134	14.5	100	75	24.6	38.1	56	28.1	41.8
21% or more less	118	12.8	100	45	14.8	39.0	31	15.6	26.3

EXHIBIT E

EXHIBIT F EXHIBIT F

SUBSIDY FUNDS REQUIRED FOR EACH DOLLAR LOANED*

Government's Cost of Borrowing (CBO Rate	REA Loan Interest Rate								
	5%	5.5%	6%	6.5%	7%	7.5%	8%	8.5%	9%
	-dollars-								
9%	.369	.327	.276	.234	.193	.142	.098	.046	-
10%	.426	.388	.341	.304	.265	.219	.178	.131	.085
11%	.476	.441	.398	.363	.328	.285	.247	.204	.162
12%	.533	.485	.446	.414	.381	.342	.306	.267	.227

*Based on monthly payments of interest only for the first 3 years with monthly principal and interest payments thereafter for the remaining 32 years on a 35 year loan.

ASSUMPTIONS USED TO PREPARE EXHIBIT A

--All capital is used to purchase assets subject to the investment tax credit (10%).

--The depreciation base is equal to the capital assets purchased less 50 percent of the investment tax credit. No salvage value is assumed.

--Assets are subject to accelerated depreciation over 15 years (straight-line basis) and straight-line depreciation over 35 years, which is the term for REA loans.

--The income taxes lost from accelerated depreciation represents the difference in the tax savings to IOUs between accelerated depreciation and straight-line depreciation assuming a standard corporate income tax rate of 46 percent after discount savings to their present value at 11 percent based on the Government's cost of long-term borrowing in June 1983.

--IOU's raised their capital through the sale of utility bonds, therefore no federal income taxes would be lost through tax benefits aimed at encouraging the reinvestment of stock dividends.

--The taxes lost on tax-exempt public utility bonds represents the taxes investors would have paid had they received semi-annual interest payments at 13 percent on 25-year term bonds and had an effective marginal tax rate of 30 percent, after discounting the annual taxes at 11 percent. The 13 percent rate represents the average yield investors would have received had they purchased taxable utility bonds issued by IOU's. The 30 percent tax rate is the bracket Treasury uses to calculate the incremental impact of tax-exempt bonds on the Federal deficit. For easy in calculating the taxes lost, we assumed PU's were issuing 25-year term bonds. In actuality, series bonds are used and because they provide for the periodic repayment of principal over the loan term, the actual taxes lost would be less than that shown.

--All REA loans were obtained at the maximum 5 percent interest rate, or 6 percentage points less than the government's 11 percent cost of borrowing in June 1983.

--Federal income taxes lost from the tax-exempt status of PU's and REC's have no impact on the cost of capital as they are related directly to income.

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

LEGISLATION NEEDED TO
IMPROVE ADMINISTRATION OF
TAX EXEMPTION PROVISIONS
FOR ELECTRIC COOPERATIVES

DIGEST

Because electric cooperatives are exempt from Federal income taxes, GAO wanted to know whether the laws are adequate and whether they are being effectively administered by IRS. GAO found that since electric cooperatives were granted exemption almost 60 years ago, the operations of many cooperatives and the environment in which they do business have changed substantially.

In administering tax exemption, IRS has tried to recognize the changes in electric cooperatives. However, it has had difficulty doing so because of the broad nature of the statute. The law generally exempts all electric cooperatives regardless of differences in their operations and activities, financial condition, size, or mix of consumers served.

IRS needs to make administrative changes to better enforce existing tax exemption provisions. More importantly, the Congress, using alternatives suggested by GAO as a guide, should establish a tax treatment which better recognizes the changing operations and present day environment of many electric cooperatives and their continuing need for assistance.

MANY ELECTRIC COOPERATIVES HAVE CHANGED SUBSTANTIALLY

Originally, most electric cooperatives were small associations which distributed electricity to sparsely populated rural areas. These cooperatives were made exempt from Federal income taxes under section 501(c)(12) of the Internal Revenue Code, which provides exempt status to mutual or cooperative companies deriving their income principally from members.

JANUARY 5, 1983

Today, many electric cooperatives serve both rural and suburban areas and closely resemble investor-owned utility companies in their operations and activities. In 1935, only about 30 electric distribution cooperatives existed, the largest of which had 63 miles of line and just 350 members. As of 1981, 920 electric distribution and power supply cooperatives were in operation with an average of 2,020 miles of line and about 10,400 consumers. Moreover, electric cooperatives' total operating revenues grew from $230 million in 1950 to about $7.4 billion in 1981.

Some electric cooperatives have expanded their activities by forming subsidiaries and associations of cooperatives which generate power, provide financing, own and lease coal mining properties and facilities, procure fuel and supplies, and provide ancillary business services. Others have expanded through the acquisition of small investor-owned utilities and interests in jointly-owned power generation plants. (See pp. 9 to 21.)

Another indication of electric cooperative growth is that many cooperatives have been able to accumulate and retain substantial amounts of member equity or patronage capital--about $3.9 billion as of December 31, 1981. A basic cooperative operating principle is that cooperatives should provide service at cost and distribute any margins or savings to members in proportion to their business or patronage. Under this principle the actual refunding of members' patronage capital is a management decision based on an assessment of cooperative operating needs and planned growth. Some cooperatives are using equity management plans to assist in balancing their financial requirements with their need to return members' patronage capital. Others have no such plans or intentions to establish them. (See pp. 34 to 38.)

IRS HAS PROBLEMS ADMINISTERING TAX EXEMPTION PROVISIONS

In administering tax exemption, IRS has tried to consider the changes in electric cooperatives' operations and the environment in which they do business. It has taken positions on tax exemption issues and has published requirements electric cooperatives must meet to qualify for exempt status. However, IRS has been hampered by the broad legislation which has not changed significantly since the 1920s and, thus, does not reflect differences in many present day cooperatives. (See pp. 42 to 44.)

IRS' compliance program centers on the one specific legislative criteria--the requirement that 85 percent or more of a cooperative's income be collected from members for the sole purpose of meeting losses and expenses. But even this requirement has proven difficult for IRS to administer and for electric cooperatives to comply with. IRS has not provided sufficient guidance for cooperatives to properly compute the member income test. Furthermore, in view of the significant amounts of tax-free nonmember income permitted under law--more than $160 million in 1981--it is questionable whether the 85 percent member income requirement is still the best way to assist small cooperatives. (See pp. 45 to 48.)

To facilitate IRS' administration of tax exemption, GAO recommends that IRS take certain actions, including providing more complete guidance on the computation of the member income test. (See p. 49.)

GAO RECOMMENDS ADOPTION OF A TAX TREATMENT WHICH BETTER RECOGNIZES CHANGES IN SOME ELECTRIC COOPERATIVES

Unlike Federal assistance programs which can be directed to those organizations having a continuing need for assistance, tax exemption applies across-the-board to all electric cooperatives. Thus, despite changes in the operations and activities of some electric cooperatives, all cooperatives continue to benefit from tax exemption provided they meet the broad statutory requirements of section 501(c)(12) of the Internal Revenue Code.

GAO recommends that the Congress establish a tax treatment to better recognize the changes in electric cooperatives' operations and activities. To this end, GAO proposes alternatives to the present law which would (1) modify electric cooperatives' nonmember income allowance, or (2) eliminate that allowance, and/or (3) apply tax rules already applicable to other types of cooperatives. GAO emphasizes that these alternatives, which would have an estimated revenue impact ranging from $2 million to $45 million, are by no means all inclusive. Rather, GAO suggests them as a framework for the Congress' consideration. (See pp. 54 to 56.)

AGENCY COMMENTS AND GAO'S EVALUATION

The National Rural Electric Cooperative Association, IRS, and the Departments of Agriculture and the Treasury comments ranged from general agreement on administrative issues by IRS to total disagreement by NRECA. The Edison Electric Institute was also asked to comment but declined the opportunity. (See Apps. V to VIII.)

NRECA disagreed with GAO's conclusions regarding the changes in the circumstances which initially motivated Federal Government involvement in rural electrification and on the extent to which present day cooperative operations and activities have changed. In contrast, IRS stated that electric cooperatives are much different today. GAO reemphasizes that while the special circumstances and operating environment of some cooperatives may not have changed, those of others have changed substantially. Yet, tax exemption continues to apply across-the-board to all electric cooperatives and does not recognize differences in their operations. (See pp. 31 to 33.)

Agriculture and NRECA contended that the report does not recognize the need for electric cooperatives to retain member equity and that taxing cooperatives could affect their ability to build up equity levels. GAO recognizes that cooperatives need to retain equity capital to become self-sufficient but emphasizes that in accordance with cooperative operating principles, cooperatives are to return to members amounts accumulated above reasonable business needs. GAO also believes that cooperatives could find equity management plans useful for assuring that a proper balance is achieved between building needed equity and returning patronage capital and suggests that REA encourage the use of such plans. (See pp. 40 and 41.)

GAO also points out that under its proposed alternatives, electric cooperatives generally would be taxed only on their nonmember income and that such taxes should have little impact on electric cooperatives' ability to build equity. Moreover, these tax treatments would better recognize the differences in present day electric cooperatives and would be a step towards more equitable taxation of the Nation's electric consumers. (See pp. 59 and 60.)

NRECA also disagreed with GAO's findings and conclusions concerning the problems and difficulties related to IRS' administration of the tax exemption provisions. In contrast, IRS essentially agreed with GAO in this regard. (See pp. 51 to 53.)

Treasury commented that GAO's proposed alternatives should have included the outright repeal of tax exemption. In this regard, Treasury questioned the need for any type of Federal subsidization of cooperatives and stated that GAO's report should have been expanded to cover all types of assistance to electric cooperatives. GAO points out that while the issues raised by Treasury merit consideration, they were not within the scope of GAO's review. (See pp. 8 and 59.)

SUMMARY FROM THE DEPARTMENT OF AGRICULTURE'S OFFICE OF INSPECTOR GENERAL'S MAY 20, 1983, REPORT ON "LOAN MAKING POLICIES FOR ELECTRIC DISTRIBUTION COOPERATIVES"

I - SUMMARY OF AUDIT RESULTS

Our analysis of the Rural Electrification Administration's operation of the revolving fund and loan-making policies and procedures, and our review of 32 electric distribution cooperatives disclosed significant problems within the electric loan program. The revolving fund is rapidly deteriorating and will eventually require Congressional appropriations unless interest rates can be increased and loan criteria changed. We found that cooperatives receive REA assistance regardless of financial need or whether they still serve rural areas. Operating procedures also need to be strengthened to ensure that loan funds are disbursed and used only for purposes approved in the 2-year work plan.

The following summaries describe these problems:

- Because REA is required by law to limit interest rates to 5 percent on loans made from the revolving fund, and because the cost of Government borrowing over the past 10 years has significantly exceeded those rates, REA has begun selling the fund's assets to finance the program. By 1985, REA's interest expense will exceed interest income. Unless interest rates charged to borrowers are increased to reflect the cost of Government borrowing, and/or loan criteria and ratios are changed, REA will have to seek Congressional appropriations to subsidize the fund. These monies would be in addition to the $307 million a year in subsidies presently obtained through interest-free notes to the U.S. Treasury. The subsidies have totaled about $2.8 billion through September 30, 1982. Both our current audit and a prior General Accounting Office (GAO) report have shown that many cooperatives could obtain outside financing at higher interest rates without a significant adverse effect to rural electric users.

  REA and the Office of General Counsel have interpreted the Rural Electrification Act and Congressional Directives to allow loans to be made to cooperatives regardless of their financial strength or the urban/rural characteristics of their service areas. Consequently, REA continues to provide loans to borrowers whose service areas are no longer rural, as defined in the Act, and to borrowers that are financially sound and could obtain credit from other sources. Many of these cooperatives' retail electric rates are lower than comparable investor-owned utilities. We selected 50 cooperatives which according to TIER and equity ratios appeared to be financially sound to determine if their financial positions were similar to those of neighboring investor-owned or municipal systems. We found that 44 of the cooperatives were in a stronger financial position than neighboring investor-owned or municipal utilities providing similar services.

- We also determined the effect higher interest rates would have on these cooperatives. For 37 of the 50 cooperatives which had received an REA loan in the past 5 years, we noted that increasing cost of interest (to reflect the cost of borrowing to the Government) did not alter the retail electric rates substantially. REA itself has determined that over 45 percent of REA cooperatives currently have retail electric rates lower than those of comparable investor-owned utilities. GAO reports have also shown cooperatives could qualify for financing at commercial terms and still provide electric service with no significant increases in residential electric rates.

- Our judgment sample of 38 cooperatives located within 50 miles of a large urban center disclosed 34 whose service areas were no longer entirely rural. A detailed review of 9 of the 34 cooperatives revealed that they were predominantly serving the suburban residents of major metropolitan areas. For example, 76 percent of the 34,000 consumers of one cooperative lived in the suburban communities surrounding Washington, D.C. The median household income of these consumers was over $25,000 or 22 percent higher than the national average. The nine cooperatives received recent REA loans totaling over $147 million.

- Although REA requires borrowers to submit a work plan that specifies the intended use of the loan funds, we noted during our reviews of 32 cooperatives that borrowers did not always limit the use of the loan funds to these authorized purposes. Twenty-six of the cooperatives used funds for purposes not included in the work plan, and 20 reapplied for new loan funds, using portions of the previously approved and funded but unbuilt items in the work plans as the basis for the new loan requests. At least $61.9 million of the $421 million in REA and supplemental loans made to the 32 cooperatives were advanced on work orders which contained unapproved construction items and for work completed in prior work plans. For example, at one cooperative over $28 million was approved for three work plans. We found that the cooperative used $6.6 million for purposes not included in the plans and did so without REA approval. We also noted that shortly after obtaining the loan advances, the cooperative invested $4.2 million of the monies at rates ranging from 13.25 to 16 percent.

- REA attempts to control loan disbursements to cooperatives by requiring that their general fund levels fall below 8 percent of Total Utility Plant before loan advances can be made.

However, we found that cooperatives often circumvented this control. In one instance, REA officials provided information which assisted a cooperative in obtaining an unnecessary loan advance. These conditions allowed 22 of the 32 cooperatives reviewed to drawdown $44 million in loan funds prematurely or without immediate need for the funds. Of this amount, over $33 million (borrowed from REA at 2 or 5 percent) was invested in high-yield certificates for periods of 90 days or more and at terms up to 20.75 percent. For example, one cooperative reduced its general fund level below 8 percent 18 times to obtain loan advances totaling $18 million. To accomplish this, the cooperative prepaid power costs, prepurchased supplemental financing certificates, prepaid long-term debt to REA and retired patronage capital. The cooperative invested $1.1 million of the loan draws in high-yield certificates for periods in excess of 90 days.

II - RECOMMENDATIONS

ADMINISTRATOR, RURAL ELECTRIFICATION ADMINISTRATION

1. Seek legislative authority to change loan-making criteria and ratios, in combination with an increase in the insured loan interest rates up to the Government cost of borrowing, to improve the financial condition of the Revolving Fund. REA should reduce and subsequently eliminate Federal funding to cooperatives capable of obtaining financing from non-Federal sources and assign interest rates based upon borrowers' ability to pay. (See Details - 1 and 2.)

2. Establish criteria to evaluate cooperative needs for REA financing based upon an individual cooperative's financial strength and retail electric rates. Require cooperatives to establish retail electric rates, whenever possible, which ultimately enable them to obtain total outside financing. (See Details - 2.)

3. Request legislative authority to redefine eligible rural areas. This should take into account the significant changes in population patterns which have occurred since the inception of the Rural Electrification Act. (See Details - 2.)

4. Identify those cooperatives which no longer serve an eligible area and/or are financially strong, and evaluate their need for continued REA assistance. For those cooperatives which are in an urban area, and which cannot secure outside financing, develop a system of diminishing assistance (with reasonable timeframes) according to the cooperatives' financial condition. (See Details - 2.)

5. Require that borrowers use loan funds only for items contained in an approved construction work plan, and instruct borrowers to obtain REA approval of changes in work plans before loan funds are advanced for these purposes. Discontinue the practice of reimbursing cooperatives for work completed prior to the period of the work plan. (See Details - 3.)

6. Use REA field personnel to conduct reviews to assure that funds are used only for loan purposes identified in the approved work plan and that cooperatives' requests for loan advances comply with applicable procedures. Review each cooperative's use of general funds to identify nonconstruction transactions having a material effect on the cooperative's general fund level at the time of the loan request. (See Details - 3 and 4.)

7. Disburse loan funds to cooperatives according to their use of general funds for current approved construction expenditures, and according to their need for the funds at the time of the loan request. In determining need, establish policy regarding recent expenditures for nonconstruction purposes and their effect on the general fund level at the time of the loan request. (See Details - 4.)

8. Establish policy to deobligate all unadvanced loan funds after the expiration of a reasonable timeframe. Take action to deobligate all outstanding advances that fall outside the established constraints and ensure timely monitoring of unliquidated obligations in the future. (See Details - 4.)

Statement of Mr. Rex Carpenter, General Manager
Nebraska Rural Electric Association

Chairman Hawkins and Members of the Subcommittee:

My name is Rex Carpenter. I am the general manager of the Nebraska Rural Electric Association (Box 82048, Lincoln, NE 68501). The association represents 33 rural electric systems (rural public power districts and rural electric cooperatives) that serve more than 130,000 consumers in the state of Nebraska. The vast majority of our consumers are farmers and ranchers.

The membership of the Nebraska Rural Electric Association strongly supports S. 1300, the Rural Electric and Telephone Revolving Fund Self-Sufficiency Act. (Resolution attached.) We would urge that the Subcommittee and the full Committee give this bill prompt and favorable consideration. In fact, we would like to stress the need for timely consideration, knowing that relatively few legislative days remain on the calendar for this session of the Congress.

The Rural Electric and Telephone Revolving Fund Self-Sufficiency Act, in our view, is needed -- not only to make those changes necessary to restore balance to the Revolving Fund in a timely manner -- but to ensure that the rural electic systems in Nebraska and the nation have continued access to capital at interest rates that are affordable so as to maintain a comparability in electric service and rates to rural Americans.

A couple of years ago, the State of Nebraska commissioned a research firm to do a national survey to find out how Nebraska was regarded by people who live outside of Nebraska. The results of this study were later summed up in three words in a headline in The Lincoln Star: "Remote, Limited, Harsh."

Of course, those of us who live in Nebraska generally would not agree with these perceptions of our state. But, to the extent such perceptions may ever have had basis in history, the state of Nebraska is less remote, less limited, and less harsh today because of rural electrification.

In fact, before REA was established, the words "remote," "limited," and "harsh" could have been used to describe almost all of rural America.

As Senator Zorinsky said in his own statement to this subcommittee on March 20, "Not only did the REA program bring rural America into the 20th century in terms of helping ease the tremendous physical burdens that were the lot of our farmers and their families before electricity, but the REA loan programs played a large role in increasing the productivity of the American farmer and our rural communities." The net effect has been to improve the quality of life and to increase productivity in rural Nebraska and rural America. These benefits also have accrued to the nation as a whole.

What has been achieved by the electrification of our rural areas is not based simply on the fact that REA provided a mechanism for establishing rural electric systems, but the success of the rural electric program has depended to a large extent on the policy decisions made by the Congress: 1) that adequate amounts of capital would be provided through REA, and 2) that the interest rates for REA loans would be as low as possible.

These policies demonstrated that there was a recognition of the following facts: 1) an electric system is extremely capital intensive, especially so in rural areas, and 2) rural electric systems do not represent an attractive investment opportunity for private investors because rural electric systems are obligated to serve those parts of America with low consumer density, which, in turn, means higher costs per meter and less revenues per mile of line. The private investors willing to consider rural America generally would require a higher rate of interest to be paid. This would be destructive in our view.

Nebraska's rural electric systems paid $6,044,000 in interest in 1982 (the last year for which data is available). After deducting wholesale power costs, the $6,044,000 represented slightly more than 11% of those system's net operating revenues of $54,698,000. (At that time, by the way, the average interest cost to Nebraska's rural electric systems was less than 2.3%.) Obviously, as interest rates are raised, the charges for electric service must be increased.

The importance of the REA program as it has been supported by the Congress is that it has provided the nation's rural electric systems access to adequate amounts of capital and at interest rates that provide for some measure of comparability in terms of service and rates. However, I hasten to add that according to the Department of Energy's publication "Typical Electric Bills, January 1, 1982," rural electric consumers in Nebraska paid an average of 40 percent more for the kilowatt-hours they used than their cousins in Nebraska's towns and cities.

The significance of S. 1300 is that it represents a continued recognition of the realities and the benefits of providing electric service in rural America by making sure that the nation's rural electric systems have continued access to capital even though it will be at a higher rate of interest.

The only other alternatives we've heard to date would drastically curtail the rural electric systems' access to the capital they need and would raise interest rates to a point where rates would have to be raised to such a level as to destroy any semblence of rate comparability in rural America. These alternatives would be counter-productive to the purposes of the REA program. The damage would not only be felt in rural America, but eventually in our cities and towns as well.

In our view, S. 1300 represents a reasonable compromise to the problems which have prompted the proposed amendments to the Rural Electrification Act. On one hand, the REA Revolving Fund will be made self-sufficient as the rural electric systems pay more for the funds they borrow. And, on the other hand, the Revolving Fund will be established as a long-term source of the rural electrics' capital needs.

Again, we would urge your support for S. 1300.

Thank you for giving me this opportunity to speak.

RESOLUTION

Rural Electric Self-Sufficiency Act

WHEREAS, legislation has been introduced in Congress entitled the "Rural Electrification and Telephone Self-Sufficiency Act of 1983" (S. 1300 and H.R. 3050). This important legislation incorporates the membership-endorsed recommendations of the NRECA Committee on Financing for the Future and has received widespread bipartisan support in Congress. If enacted, the legislation should provide the following benefits:

> Restore balance and long term stability to the Rural Electric and Telephone Revolving Fund through periodic revision of the standard rate on REA insured loans; and
>
> Stabilize the federal investment in the Revolving Fund by converting funds appropriated by Congress for loans made prior to 1973 into a permanent capital investment in the Fund; and
>
> Meet the special needs of borrowers which operate in very difficult economic circumstances, including serving sparsely settled rural areas, through a congressionally mandated special interest rate in the Revolving Fund which would be funded through a combination of a portion of those funds converted to the permanent capital of the Revolving Fund and from appropriations when necessary; and
>
> Facilitate the future growth of supplemental financing through provisions to adjust ratios as needed, and encourage the sharing of REA's security interest in its borrowers; and
>
> Preserve the present REA loan guarantee program in its present form, including continued access to the Federal Financing Bank for the funding of these loans; and
>
> Enable the refinancing of loan guarantees and CBOs when interest rates drop at least one percentage point.

THEREFORE, BE IT RESOLVED that the National Rural Electric Cooperative Association strongly urges Congress to support this critically important legislation.

Approved by the Nebraska Rural Electric Association Board of Directors, September 15, 1983, Kearney, Nebraska.

STATEMENT OF MR. LESTER L. MURPHY, JR.
Executive Vice President, Kansas Electric Cooperatives, Inc.

Chairman Hawkins and other distinguished members of the Subcommittee on Agricultural Credit and Rural Electrification.

My name is Lester L. Murphy, Jr., and I am the Executive Vice President of the Kansas Electric Cooperatives, Inc., (KEC). Kansas Electric Cooperatives, Inc., is the statewide association of the rural electric cooperatives of Kansas. There are 38 Kansas rural electric cooperatives (RECs) serving electricity to more than 450,000 Kansans.

Madam Chairman, I am most pleased to have the opportunity to present the views of the Kansas RECs in support of S. 1300, the Rural Electric and Telephone Revolving Fund Self Sufficiency Act.

The cooperatives in Kansas are very much aware of the need for an adequate and affordable rural electrification loan program. We view S. 1300 as a fair and equitable solution to the problem of the depletion of the Rural Electric Revolving Fund.

A strong REA loan program is essential to the electric cooperatives of Kansas. It is one of the major determinates in providing an adequate and reliable supply of electric energy at a cost reasonable comparable to those paid by urban consumers. The RECs serve very sparsely populated areas. Although the national average for the rural electric cooperatives is 4.7 consumers per mile, in Kansas, it is only 2.4 consumers per mile or approximately one-half the national average. Nearly one-half of the Kansas systems have less than 2.0 consumers per mile. Although the Kansas RECs geographic territory extends over 80% of the state of Kansas, they serve only 20% of the population. This, of course, means the distribution plant investment per consumer is quite high. The Revolving Fund is the major source of funds for serving these consumers.

Another factor associated with the many miles of lines required to serve so few consumers, is the exposure to adverse weather conditions. The Kansas RECs vividly recall the disastrous consequences of an ice storm which struck on March 18 and 19 of this year, leaving approximately 85,000 rural consumers without electricity. Many of these consumers struggled without power for a week before lines could be restored. Preliminary estimates indicate that restoration costs will amount to approximately $2.5 million. The cost of correcting the storm damage has seriously depleted the affected systems' loan funds, thereby necessitating the premature application for new loans from REA or the reapplication of loan funds from their intended purpose. Again, the source of these funds is the Revolving Fund.

One feature of the proposed legislation would provide the Administrator of the Rural Electrification Administration (REA) the alternative to set special interest rates for cooperatives warranting special assistance. Restoration of severe storm damage frequently falls within this category and severe weather conditions seem to frequently befall us in Kansas.

While the cost of the distribution facilities to provide service are important, these costs no longer account for the bulk of a consumers bill. Since the oil embargo of the 1970s, the cost of power generation has rapidly escalated to the single most costly component of electric utility bills. In the case of the Kansas RECs, on the average, 70% of the consumer-members bill is wholesale power cost. The implementation of federally mandated fuel switching policies has resulted in dramatic cost increases for the construction of nuclear, coal and other alternative power generation facilities.

In Kansas the RECs are relative newcomers to power generation and transmission. We have two Generation and Transmission (G&T) Cooperatives, Sunflower Electric Cooperative, Hays, and Kansas Electric Power Cooperative, (KEPCo), Topeka. In August, 1983, Sunflower completed a new 280 megawatt coal-fired plant, on schedule and on budget, I might add. This plant addition resulted in approximately a 29 to 34% increase in rates at the wholesale level with only 47% of the total cost of the plant in rate base. The remaining plant capacity will be phased-in over a period of several years.

KEPCo, which has only been in existence since 1974, is a 6% partner in the Wolf Creek Generating Station, our first nuclear generation facility in Kansas. KEPCo projects wholesale rat incrases of approximately 41% when Wolf Creek comes on-line, which translates to retail rate hikes for distribution cooperative consumers in the range of 25 to 33%.

The efforts of these G&T Cooperatives have been essential to the viability and success of rural electrification in Kansas, but new power plants and transmission facilities are expensive. Since all of the G&Ts power resources are relatively new, they carry a high embedded cost. This is the reason a strong guaranteed loan program and the provisions for lien subordination and accommodation in S. 1300 are so crucial.

One other area I would like to discuss is the effect of "rate shock" on American agriculture. "Rate shock" is a term that has recently been used in the Kansas Legislature as state lawmakers worked frantically for the last several weeks to fashion legislation designed to ease the impact of electric and telephone rate increases on residential and business ratepayers in the state of Kansas. In Kansas, rural consumers already pay more for electricity than their urban counterparts. Without a strong rural electric program, Kansas agriculture may not be able to withstand the projected impact of "rate shock".

I would like to conclude my testimony by relating a discussion I had on Monday evening of this week with a member of one of the Kansas RECs. This was immediately following the annual meeting of his cooperative. He had been reading aout proposals to curtail or eliminate the REA loan program and was wondering how cooperatives, such as his, were to survive. He knew he was already paying more for his electricity than those in town and it wa just announced at the annual meeting that his cooperative was filing for a retail rat increase. This increase amounts to approximately 17% and results from the construction of a new substation and related facilities to serve a recently completed federal reservoir and a federally financed water treatment plant. It was also pointed out in the meeting that when his power supplier's nuclear generating plant comes on-line in 1985, he will experience another 28.6% increase in his retail rates. His question was, if all these things come to pass, as projected, how can I or my cooperative survive on 12¢ per kilowatt hour electricity?

Part of the answer to this consumer's question is being addressed in this legislation. That is, the maintenance of a reliable and asdequate REA Revolving Fund.

Madam Chairman, I truly appreciate the opportunity to appear before this distinguished panel to relate some specific information about the Kansas rural electrification program. On behalf of the Kansas RECs who depend on REA for their financing, I hope you will give prompt and favorable consideration to S. 1300.

I will be happy to answer any questions you or the other members of the subcommittee may have.

STATEMENT OF MR. JAMES M. HUBBARD, EXECUTIVE VICE PRESIDENT NORTH CAROLINA ASSOCIATION OF ELECTRIC COOPERATIVES, INC.

Madam Chairman, and distinguished members of the Committee, I am James M. Hubbard, executive vice president and general manager of the North Carolina Association of Electric Cooperatives which is comprised of 28 electric cooperatives serving over 455,000 meters representing well over a million citizens residing in the sparsely settled rural 60% of the land area of North Carolina.

These figures place in sharp focus the reality of the statement that economic health of the electric cooperatives in our State has a direct and immediate impact upon the financial well being of our farmers, rural businesses, and rural citizens in general.

Speaking on behalf of our cooperatives and their member/owners, I urge the member of the subcommittee to support the timely enactment of S. 1300, the "Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983."

In just over a year our nation will be celebrating the 50th Anniversary of the Rural Electric Program--a truly bi-partisan partnership between government and people. This rural American success story need not be repeated to this distinguished committee.

As we approach the second half century of service, rural electric cooperatives are still operating in the areas which other utilities could not or would not serve. Co-ops still, by and large, serve thinly populated territories--in our state only 6.5 consumers per mile of line. Nationwide the co-ops have built and maintain 50% of the nation's electric lines, but account for less than 10% of its total electric sales. The average electric cooperative's revenue per mile of installed line is about 8% of that enjoyed by the average power company. At the same time, however, the co-op's investment per consumer is 162% of the investment of the power company.

Is it fair to expect our nation's rural cooperatives with an average consumer density of 4.7 per mile of line to pay more for their financing than, for example, our municipal systems with an average of 77.5 consumers per mile of distribution line? I respectfully suggest that it is not.

All of the factors outlined above contribute to the difficult financial and economic conditions in which electric cooperatives operate. In our state over 2/3 of our system rates are higher than those of the investor-owned companies. Because of these problems, the creation of a stable and adequate REA lending program as the center piece of rural electric financing is vital to the future survival of affordable rural electrification in America.

Co-ops borrow funds for one reason only -- to build the facilities needed to provide adequate service to their rural consumer-members. The only alternative is to refuse service to the new home, farm and business loads developing in rural America. Unlike some other business entities, we do not have that option.

S. 1300 is the product of nearly a year of intensive study by a broad cross-section of distinguished individuals who are experienced and knowledgeable leaders from every segment of the rural electric program. An over-riding consideration of their part was improving the productivity and quality of life in rural America by ensuring that all rural citizens have access to an adequate and reliable supply of electric energy at a cost reasonably comparable to that paid by the residents of our cities and towns.

S. 1300 has been characterized as "budget busting" and a "forgiveness" of debt. In fact the legislation will raise interest rates for rural electric systems and reduce government competition in the money market. The Act will not "forgive" any debt by any rural electric system. Further, it will not "cost" the government $20 billion as claimed by opponents. This is simply a propaganda figure manufactured out of circumstances totally unlikely to occur, namely that interest rates will drop to about 6% and that the Administrator of REA and the Secretary of the Treasury will agree to re-finance all outstanding Treasury loans to REA and all loans guaranteed by the REA to rural electric borrowers. The Congressional Budget Office indicates that the Act is essentially a wash cost-wise. The Act maintains the REA Revolving Fund in the simplest way possible, and creates no new lending programs.

We're trying to keep the power on in rural America without running the costs through the roof. Under S. 1300 the cooperatives will carry their own weight and pay their own way. Rural electric cooperative members are entitled to the equitable treatment the Self-Sufficiency Act provides.

Thank you for this opportunity to present our views to the Committee.

STATEMENT OF ROBERT R. EDMISTON
PRINCIPAL, LEHMAN BROTHERS KUHN LOEB INCORPORATED
INVESTMENT BANKERS, NEW YORK

Senator Hawkins and Members of the Committee:

I appreciate the opportunity to discuss various aspects of private market financing for rural electric cooperatives. My firm, Lehman Brothers Kuhn Loeb Incorporated, has been closely identified with the financing of rural electric cooperatives for almost two decades. It has served as principal investment banker for National Rural Utilities Cooperative Finance Corporation ("CFC") since its founding fourteen years ago. My primary responsibility for the past seven years has been the providing of various investment banking services to rural electric cooperatives principally through CFC.

Development of Private Market Financing for Rural Electric Cooperatives

The rural electrification program is about to enter its sixth decade having undertaken to render a continuing public service, essential to the health, safety and livelihood of their rural member consumers. It is a proud record of achievement. Government support has been used intelligently and with integrity to build a sound industry of over 1,000 electric utility systems. Also, these utility systems have not been satisfied to rely solely on government financing; beginning fifteen years ago, they instituted a "self-help" effort which resulted in the formation of National Rural Utilities Cooperative Finance Corporation ("CFC") as an independently financed, membership-owned institution to supplement the federal financing program. This unique financial intermediary has been the principal means by which rural electric cooperatives have accessed the private capital markets. CFC now has in place loans, commitments and guarantees of approximately $7.9 billion.

CFC, created in 1969, was an untried and untested financial institution that had one overriding objective: to provide its members with reliable and cost effective access to private capital markets in order to supplement the Rural Electrification Administration ("REA") program. Fundamental to the achievement of this objective was the realization that the rural electric systems could obtain capital at a lower cost by working together than they could by marketing their credits individually.

Prior to the formation of CFC, non-REA financing was rather modest. As far back as 1968, the 28 distribution cooperatives in Ohio combined in Buckeye Power, Inc. to finance a 615mw coal fired unit. The unit cost was $72,000,000 and the sale of $62,000,000 of first mortgage debt to a group of insurance companies was the first time the rural electric cooperatives had entered the private capital market. The cooperatives at that time were a complete unknown to investors. In the case of Buckeye, investors were able to place primary reliance for the creditworthiness of the project on the fact that Ohio Power Company, then an AA rated subsidiary of American Electric Power Co., was committed on a take or pay basis for all the output of the plant not utilized by the member cooperatives.

In the early 1970's the REA, CFC and private investors jointly financed the $125,000,000 Charleston Bottoms project in Kentucky. Outside first mortgage financing was obtained principally from insurance companies for 60% of project cost.

CFC has, since the inception of its loan program in 1973, provided about $1.9 billion of long-term loans to its members, and has constituted by far the major source of private funds to supplement REA-insured loans to distribution cooperatives.

The major source of financing for power supply cooperatives has been through the funding of REA guarantees by the Federal Financing Bank. Private-market financing by power supply cooperatives to date exceeds in gross amount that of distribution systems, and has been much more diversified in source of funding, with greater reliance on direct issuance. Whereas all but a negligible amount of supplemental financing for distribution systems was secured from CFC, significant sources of supplemental funds for power supply cooperatives have been the tax-exempt pollution control revenue bond market, lease transactions, the Banks for Cooperatives and commercial banks.

While CFC has not had as primary a role in power supply supplemental financing as it has for its distribution members its participation has been significant. CFC has advanced and committed to date over $250 million in direct long-term loans to power supply systems. It also has approximately $750 million outstanding in intermediate term loans and commitments and has provided in past years a total of $3.6 billion in intermediate loans, principally to finance front-end expenditures for power plant construction. In addition, CFC has provided its guarantee for approximately $1.4 billion of tax-exempt pollution control revenue bond financing.

Several cooperatives have entered the tax-exempt market on their own credit while others have used credit support, generally a commercial bank letter of credit. Directly-issued obligations of this type total about $1.5 billion.

In the past several years power supply cooperatives increasingly have taken advantage of leasing, in various forms, to supplement conventional borrowing as a means of financing the acquisition of capital assets.

Another source of private market borrowing for rural electric cooperatives has been the Banks for Cooperatives. At year end 1982 the Banks for Cooperatives had approximately $1.1 billion committed to rural electric cooperatives. Most of its loans have been made to power supply cooperatives for the purpose of funding REA guarantee commitments. They have also provided some short-term funding and lease guarantees for eligible power supply cooperatives, and a small amount of short and long-term loans have been made to distribution cooperatives.

Rural electric cooperatives have steadily enlarged their participation in the private capital markets in recent years. Their securities are gaining increased market acceptance. However, the percentage of long-term debt obtained outside the REA has not changed much in recent years as the REA annually, through its direct and guarantee loan programs, continues to supply about 90% of long-term debt requirements for the rural electric cooperatives. While the percentage has changed very little, there has been a tremendous expansion of investment in power supply facilities by the cooperatives in all regions of the country to keep up with demand. From 1973, when the REA act was amended to authorize loan guarantees, through 1983, REA had guaranteed about $33 billion for power supply financing requirements. Thus while the increase in private market financing for cooperatives has been significant, its share of total long-term financing has been fairly constant in recent years because of the rapid growth of capital required.

Market Acceptance of CFC

We have witnessed a steady improvement in the quality of CFC, its credit rating and investor acceptance of its obligations. CFC's credit rests on the financial strength of its member borrowers and the risks associated with any financial intermediary.

Its initial entry into the capital markets was in 1972 when it raised supplemental funds for distribution cooperatives by offering $50 million of its collateral trust bonds. At the outset, because it was a new and unique concept, untried in the market, its collateral trust bonds were given an A rating. Although this is an investment grade rating (the four investment grade categories are AAA, AA, A and BBB) and the level of most of the investor-owned utilities at that time, CFC aspired to better. In 1975 one agency upgraded CFC to AA and in 1979 it became rated AA by both of the major credit rating agencies.

To date CFC has raised $1 billion in the taxable or corporate bond market. These obligations are purchased primarily by pension funds, mutual funds and insurance companies, and enjoy widespread market acceptance. There are active secondary markets in many of the individual issues CFC has offered. These obligations have on balance traded as a strong AA credit.

CFC has also been active in two other markets - the tax-exempt market and the taxable commercial paper market.

CFC's guarantee program for tax-exempt pollution control revenue bonds issued in connection with power projects totals $1.4 billion. Such guarantees provide valuable support in attracting private (non-CFC) funding. Of the $1.4 billion of CFC-guaranteed pollution bonds outstanding, approximately $523 million is for long-term bonds and $815 million is for short-term. During the recent period of historically high interest rates, their program has offered short term tax-exempt funding flexibility either through bank loans arranged by CFC, Bond Anticipation Notes of up to three years or tax-exempt commercial paper. These obligations have been widely marketed to individuals, money market funds, bank trust departments, insurance companies and bond funds. CFC's tax-exempt obligations are presently rated Aa3 by Moody's Investors Service and AA- by Standard & Poor's Corporation.

CFC issues commercial paper -- or unsecured promissory notes issued primarily by corporations for the purpose of raising short-term funds - to provide funds for short - and intermediate-term and variable rate long-term loans to members. CFC has been very successful in attracting a large value of funds from this market. Outstandings at February 29, 1984 totaled $958 million and have been as high as of $1.3 billion. Primary investors include CFC members, corporations, bank trust departments and state and local governments. CFC's commercial paper carries the highest ratings awarded by the rating agencies and trades at the most attractive rates available to any issuer in this market.

The credit ratings and market acceptance attained by CFC signifies many things. It shows that CFC was soundly conceived by its founders and that its organization and purpose has stood the test of time. It has demonstrated that it is being prudently and responsibly operated and managed. Finally it shows confidence in the sustained quality of CFC's member-borrowers and the excellent credit record of rural electric cooperatives since their inception. In the final analysis the fundamental credit and acceptance by the marketplace depends upon the quality of its loan portfolio.

Real progress has been made in educating investors to understand not only the consumer-owned cooperative philosophy but also many of the unique characteristics of rural electric cooperatives. It is, however, a continuing process to maintain and enlarge market acceptance.

Importance of REA Financing to assure Adequate Power for Rural Electric Cooperatives

Basic to the assurance of a reliable supply of power is the availability of capital to finance needed plant additions. The securities market in recent years has become highly volatile with competition for funds -- especially long-term funds -- intensifying. Rapid and unexpected changes in interest rates, and changes in investor objectives have been revolutionizing our securities markets.

A source of continuing concern is over the depth of the market for long-term debt maturities which the financing of utility plants requires. The REA guarantee funded through the Federal Financing Bank offers loans of 35 years duration. This is the same term which the REA program has provided since the 1944 amendments to the Rural Electrification Act. The entire financial structure of the industry is based upon a rate of amortization over 35 years which coincides with the estimated useful life of the facilities. Sound utility financing is premised on financing long lived assets with long term funds.

For power supply borrowers, access to the REA guarantees with funding through the Federal Financing Bank has provided favorable borrowing costs. However, the greatest benefit which REA has consistently provided to rural electric systems is guaranteed availability of long term capital.

Given the nature and magnitude of power supply requirements ($33 billion of guarantees provided since 1973) we believe that without the REA guarantee program this volume of funds could not have been raised from the private market in the amounts and maturities required.

Our Firm recently completed a study (Report to Committee on Objectives and Planning of National Rural Utilities Cooperative Finance Corporation) which analyzed the expected capital needs of rural electric cooperatives and their ability to meet these requirements in the private capital market under various levels of government support. A summary of the conclusions of this report is appended.

The Report examined the expected capital needs of power supply cooperatives over the next few years against assumed future levels of REA support. We concluded that if REA guarantee availability is not sufficient that the private market could accommodate a portion but not all of the anticipated capital needs. Meaningful access to the private capital markets will have to be developed over a period of years and in the context of a strong continuing REA commitment during a monitored transition.

It is important to note that if the development of supplemental financing for power supply cooperatives proceeds in an orderly manner, private market capital can be attracted without a substantial and costly enhancement of rural electric financial standards. As noted in the Appendix, the means exists for power supply systems to use a collective financing vehicle, similar to CFC, to achieve the greatest efficiency of access to the capital markets at the lowest cost through the pooling of individual power supply credits.

Enhancing Capital Availability from the Private Market

As rural electric cooperatives continue their efforts to enlarge their participation in the private markets, it is essential to offer investors adequate security for their loans. The government must be willing to share equitably its all encompassing security interest with private lenders. The proposed amendment to Section 306 of the Rural Electrification Act, particularly with respect to the accommodation of liens of non-REA lenders, will facilitate and further the development of non-REA credit for rural electric cooperatives.

In our view the importance of REA accommodation of its lien to non-REA lenders requires emphasis since it is fundamental to the expansion of non-REA credit sources for rural electric cooperatives. The amendment to Section 306 of the Rural Electrification Act of 1936, specifying accommodation "upon a finding that the borrower has, or will have, the ability to repay its existing and proposed indebtedness," should provide sufficient latitude to avoid those situations wherein the REA has taken a narrow view of accommodating its lien to other lenders.

We are generally aware of procedures and policies that REA has been following in granting lien accommodations. As has been noted by CFC Governor Gill in his testimony to this Committee on March 20, 1984, several considerations appear to determine the Administrator's favorable consideration of a lien accommodation request. These include, a finding that there is a compensating benefit to the Government if the financing cannot be done by the Government, and that the physical plant of the borrower equals or exceeds the secured indebtedness of the borrower.

As to the first of these, we believe that when financing can be obtained from a private lender that this should be considered as an adequate compensating benefit to the Government. As to the second, the investment community has long held that security for borrowing is much more than a lien on the physical assets employed in the enterprise. The real measure of creditworthiness is an assessment of the continuity and consistency of the earning power of the assets over time. This should be given appropriate recognition by the REA in granting lien accommodations to non-Federal lenders.

Failure to accommodate limits the availability of non-REA credit and could force a cooperative to undertake more expensive borrowing arrangements since few lenders are willing to accept the risk of being an unsecured creditor of a cooperative whose assets are mortgaged to the REA. It is important to appreciate that the REA lien covers all assets including revenues and assets which are acquired by the borrower in the future. It is not realistic to expect lenders to grant meaningful amounts of credit in an unsecured capacity to enterprises which have all assets pledged to another lender. In the event of default or bankruptcy an unsecured lender would be at a substantial disadvantage in expecting to recover his loan. His claim against the defaulting borrower is junior by virtue of the collateralization afforded the secured lender. Failure to accommodate liens for loans that are necessary for the well being of a cooperative needlessly creates an inherently unattractive credit for non-REA lenders.

Another issue raised in the proposed amendments is the right to subordinate the debt of the REA to other lenders. This would provide a superior credit position to the debt that was senior to the subordinated REA debt. Subordination will clearly enhance the creditworthiness of cooperatives. However, fairness also dictates that the position of the government not be unduly weakened by subordination. Subordination of the security interest of the government in any loan should be carefully considered and evaluated in a judicious manner.

From the perspective of the private market lender, subordination is a marked improvement in the security position of a prospective senior lender but does not diminish the necessity of the borrower to demonstrate the ability to meet debt service payments. The foremost consideration in credit evaluation is the consistent capacity to meet fixed payment obligations over a long period of time. While some will argue that subordinated debt is debt that serves as "equity" it is nonetheless debt accorded all the customary rights and protections of a debt instrument.

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APPENDIX

REPORT TO

COMMITTEE ON OBJECTIVES AND PLANNING
OF
NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

FINDINGS AND RANKING OF FINANCING ALTERNATIVES

The Committee on Objectives and Planning ("The Committee") of National Rural Utilities Cooperative Finance Corporation ("CFC") has undertaken a major study of the future capital requirements of the rural electrification program and the possible means by which these requirements can be met, with particular emphasis on financing alternatives to the Rural Electrification Administration's ("REA") present lending programs.

As our contribution to this study, Lehman Brothers Kuhn Loeb Incorporated ("LBKL") has prepared this Report, which analyzes the anticipated financial requirements of the distribution cooperatives and the power supply generation and transmission cooperatives ("G&Ts"), places these requirements in the context of the general money markets and the competitive demands for investment funds, and reaches conclusions as to the relative merits of different private financing alternatives under varying market conditions and levels of government support. The Report also analyzes CFC's role in financing its member systems, recommends certain changes in CFC's structure, and describes a new method for the collective financing of the G&Ts with CFC support which we believe to have substantial merit. In carrying out this assignment, our overriding goal has been to balance the twin objectives of maximizing total capital availability and minimizing financing costs to the ultimate consumer.

This Report has drawn on LBKL's broad expertise as a major investment banking firm and more particularly on our knowledge of the rural electric program gained from our close association with the original Long Range Study Committee and with CFC since its formation.

In judging CFC's capabilities in the years to come, we deal with projections and prognostications. Sharing the human inability to see into the cloudy future, it has been necessary to form certain judgments about trends and markets, as well as levels of government support, interest rate levels, demand for funds and many other factors in order to draw some reasoned conclusions and develop a program for the future. We believe our hypotheses are reasonable, although they are certainly open to disagreement, and that time is likely in its wonted way to develop conditions no one could have foreseen.

Nevertheless, certain conclusions have been drawn from the study which can be summarized as follows. The justification for these conclusions and an extended discussion of the reasoning which supports them, as well as statistical and tabulated information, are contained in the following sections of the Report.

1. The capital requirements of the rural electric program will continue to be large, notwithstanding the dramatic reduction of the rate of growth in energy demand nationwide. Rural electric demand is expected to grow, although at less than historic rates. The requirements for additional capital will be strong in all sectors of the program, but particularly for power supply systems. Based upon assumptions as to load growth and inflation rates utilized in this Report, distribution cooperatives will require $12.5 billion of funding to 1990, while the G&Ts will require commitments in excess of $49 billion. (Part III)

2. The support of the REA has been essential to the success of rural electrification and has been crucial in two respects: (a) in lowering the overall cost of capital, and (b) in assuring access to capital for both the distribution and power supply cooperatives who were otherwise unqualified for funding in the capital markets. The REA guarantee-FFB funding program has proven, in our judgment, to be a unique and irreplaceable capital resource for G&T systems, and essential to the recent very dramatic expansion of the G&Ts. It is equally important, however, to stress that even the limited amount of private G&T financing that has been obtained to date could not have been obtained without strong investor confidence that the REA would

continue to play a dominant role in financing power supply systems, and that the administrative involvement of the REA in rural electric systems could be fully relied upon by lenders in the private sector. FFB access has provided a significant interest and transaction cost advantage to the G&Ts in comparison to funding of the guarantee in the private capital markets. Of much greater importance has been the guarantee itself, which assures funding flexibility and availability of long-term financing regardless of market conditions. (Part IV)

3. The supplemental financing provided by CFC, and to a lesser extent by the Banks for Cooperatives and other lenders, has been successfully integrated into the basic REA program and has enlarged the supply of capital at some higher but still acceptable cost of money. (Part IV)

4. CFC is capable of enlarging its role in providing supplemental financing for distribution cooperatives to the extent necessary. (Part V-B)

5. G&T systems have the potential for expanding their access to private capital, but within the context of a strong continuing REA guarantee program. The Committee on Objectives and Planning projects a total of $49.3 billion of capital commitments for construction programs through 1990. In our judgment, even the fullest possible exploitation of available private financing alternatives would fall short of meeting these requirements. It is particularly important to stress that even the perception of substantially diminishing REA support would limit the full utilization of available private market alternatives--that is to say, that access to the private market will be maximized if a strong ongoing REA financial and administrative commitment is assured. Given this assurance, we believe that G&T systems have several alternatives for expanding their access to private capital. (Part V-A)

6. Individual G&Ts have the capability of entering the market independently if they meet the credit standards of investors, particularly for interest coverage and capitalization ratios. There is an entrance price until the credit becomes familiar, and there will always be periods of market rejection of weaker credits. The poorer G&T credits and those with large start-up and expansion programs will have greater difficulty and may even face denial. Separate financing could set in motion intramural competitive forces which could result in increased overall costs to consumers. (Part V)

7. CFC can play a vital role in G&T financing while continuing its traditional role with its distribution members. Our Report examines the relative merits of collective action through a new financing vehicle or through CFC directly. CFC has effectively fulfilled not only its original mission of supplementing direct REA loans to distribution members, but also the added one of greatly expanding and diversifying the range of financing services it provides to its distribution and G&T members alike. We believe that CFC, with proper equity support, has a substantial ability to further expand its distribution lending and its guarantee program over time. However, in augmenting CFC's participation in providing credit to G&Ts, it is important that it be done in a manner which economizes on the use of CFC's credit capacity, which has finite limits. (Part V)

8. Collective action holds the best promise for effective private capital market access. Of the financing options we analyzed, we believe the greatest efficiency of access to the private capital markets can be obtained through a collective financing vehicle distinct from but sharing many similar concepts with CFC, and relying in varying degrees on CFC's credit strength and acknowledged favorable market acceptance during its development and operation. We believe that the pooling of individual G&T credits would provide a stronger debt rating for the securities of this vehicle than most G&T systems could

command independently, and would provide more effective leveraging of the equity capital resources of G&T members and their consumers than would independent access, thereby implying lower costs. This could be accomplished by forming a new financing entity such as the Power Supply Financing Cooperative outlined in Part V-D of this Report. It should be possible for CFC to provide management services for this new financing entity so that no significant new administrative and operational staff requirements would be imposed. While it would take some time to implement such a program, it would gradually be able to attract significant funding. The concept of strength through unity has served the rural electrification program well, and we believe the rationale that led to the founding of CFC thirteen years ago still applies today.

9. Other suggested financing options are less desirable, or less feasible, than those discussed above:

   (a) Agency Status. While the designation of CFC, or a similar organization, as a federal agency would provide undeniable benefits in terms of favorable entry to the capital markets at rates only slightly above the cost of present FFB funding, establishment of such status runs counter to reducing government involvement. Creation of agency status would require legislation and, at least initially, direct government credit support. Market acceptance of a new agency without direct government credit support would only be gradual, thus limiting the amount of funding obtainable and imposing higher required interest rates than for established agencies. Nor would agency status assure the quantity of long-term funding presently available through the REA guarantee-FFB funding program. (Part V-C)

(b) Credit Insurance. Credit insurance is an unproven form of credit support in the taxable market. We are unable to assess its cost, or the amount of credit that such a mechanism could provide. However, this option, which is currently in a developmental stage, could prove to be a method of minimizing credit risks for investors and should be further explored. (Part V-C)

(c) Banks for Cooperatives. Under existing policies, the Banks for Cooperatives have done very little co-financing with other financing entities. In addition, the Banks for Cooperatives have largely limited their financing of G&Ts to the funding of REA guarantees already in place. Even if the Banks for Cooperatives exhibited more active involvement in financing power supply systems without a federal guarantee, BC system lending restrictions and eligibility requirements limit the amounts of capital available from this source. (Parts IV-C and V-C)

(d) Other Alternatives. Lease financing, tax-exempt financing, project financing, and a variety of different types of securities--such as commercial paper and bank credit--provide a variety of valid but limited alternatives. (Part IV)

10. Any transfer of a major part of G&T financing requirements from the present government program to direct private market funding would place the cooperative sector in direct competition with the investor-owned utilities for a limited supply of long-term debt. As a result, either some debt demand could go unfilled, or interest rates could be driven up (or both), to the detriment of all utility consumers. (Part V-A)

11. Regardless of the extent to which CFC expands its responsibility for G&T funding, it should strengthen its equity base by a program

extending the duration of the subscription CTC's and lowering the cost of the loan CTC's. (Part V-B)

The present federal program, while not perfect, is a satisfactory one. Any reduction in its size and scope will impose significant additional costs upon ultimate consumers while potentially restricting the flow of long-term capital to rural electric cooperatives. A sudden elimination of the federal program would have a dramatic adverse impact; a more gradual, and limited, reduction can probably be absorbed over an extended period of time.

Following is a ranking of the primary long-term financing alternatives for G&Ts. While we have provided brief commentaries, these rankings should be considered within the context of the entire report. The interest rates used were those in effect in November, 1982 and it should be noted that the spread relationships among the various types of obligations will vary with the general level of interest rates.

RANKING OF SELECTED LONG-TERM FINANCING ALTERNATIVES FOR G&T SYSTEMS [1] [11]

	Rating	Direct cost spread over Government yield curve (basis points) as of Nov. 11, 1982			Indirect cost			Availability of long-term capital [5]	Estimated spreads over long-term Treasury	Comments
		Basic spread	Potential rate penalty [3]	Total	G&T credit standards	PSFC or equity requirement	Total [4]			
1. REA guarantee program.	Aa a/AAA	12.5	0	12.5	No change required: TIER = 1.000x. Equity ratio = 5% or less.	No change required	0	$4.6 billion in total funding in fiscal 1983. 35 year financing available as needed.	12.5	The most efficient means of assuring adequate capital availability at lowest cost during the current phase of developing G&T power supply self-sufficiency. FFB funding provides a cost effective and flexible way of funding the REA guarantee.
2. Agency status [6]	Aa a/AAA	75–125	0	75–125	do	do	0	Some initial limitation on total funds available until market acceptance established but superior to any private alternative. Access to long-term capital (i.e. 20–35 years) would be constrained by market conditions but superior to any private alternative.	75–125	Requires legislation. To assure market acceptance equivalent to existing agencies, direct government credit support such as a guarantee of its assets is required; otherwise, investors, while taking comfort from implicit government support, will evaluate the quality of the asset portfolio thus imposing higher interest costs than indicated in the direct cost column.
3. Power supply financing cooperative [PSFC].	Aa/AA	175–200	25	200–225	Minimum eligibility standards would not require change for most G&T's: TIER = 1.00x and DSC = 1.10x in 8 of 12 preceding quarters. Distribution members TIER = 1.50x and DSC = 1.25x. Maintenance of these eligibility standards would be required.	Debt service reserve [DSR] requirement only—proceeds invested in U.S. Government securities—assumed equal to maximum annual interest. Cost of DSR is negative arbitrage between interest cost of PSFC obligation and DSR earnings (approximately 200 basis points in current markets).	[8] 25–30	Subject to market conditions, sufficient long-term capital should be available through PSFC to provide primary supplemental financing needed. Availability subject to continuing strong REA program, otherwise higher direct and indirect cost will be necessary to attract capital.	225–255	Structure: Pass-through entity, bonds back-to-back with loans. Credit support and financial strength (debt service reserve, eligibility standards and maintenance requirements, CFC diversification guarantee, possible need for the collection of rates provision under all-requirements contracts) should permit the Power Supply Financing Cooperative to obtain an AA rating. Economizes use of CFC's credit support yet the limited use of CFC's credit provides the substance to bridge the gap from a start-up financing vehicle to a mature one. A collective, diversified credit will enable G&T borrowers to attract capital on advantageous terms without a significant enlargement of financial standards.
4. CFC guarantee	A2/A+	250–275	0	250–275	No change required	9% DSRC. [7] 5% STC. [7]	[8] 40–45	Limited availability as a supplement to REA—primary constraint is possible saturation of CFC credit. Availability subject to continuing strong REA program, otherwise higher direct and indirect cost will be necessary to attract capital.	290–320	CFC can support increased lending to distribution cooperatives and guarantee commitments for pollution bonds. CFC's capacity to provide direct credit support to offset a reduced REA guarantee program is limited. This limited support could be utilized most effectively in the start-up phase of PSFC.

RANKING OF SELECTED LONG-TERM FINANCING ALTERNATIVES FOR G&T SYSTEMS [1] [11]—Continued

	Rating	Direct cost spread over Government yield curve (basis points) as of Nov. 11, 1982			Indirect cost			Availability of long-term capital [5]	Estimated spreads over long-term Treasury	Comments
		Basic spread	Potential rate penalty [2]	Total	G&T credit standards	PSFC or equity requirement	Total [4]			
5. Independent access........	Ba a/BBB to A/A [3]	275–325	50	325–375	TIER=1.20–1.30x during equity buildup (if necessary) and 1.10–1.25x thereafter. Equity base of 5–10% required.	DSR required, assumed equal to maximum annual interest. Opportunity cost of equity assumed at approximately 500 basis points.	[10] 50–55	Varies between G&T issuers—generally stronger/larger systems could establish adequate access to supplement REA while weaker systems could be severely restricted. Availability for all G&T's subject to continuing strong REA program, otherwise higher direct and indirect costs will be necessary to attract capital.	375–430	Dependent upon considerations of credit quality and market acceptance; great disparity among individual G&T's: start-up situations versus mature systems. Market acceptance requires name recognition, sales efforts, and a "critical mass" of paper in the taxable market. Credit quality dependent upon strength of underlying distribution cooperatives, economics of the service area, regulatory and legislative environment, strength of underlying power contract, size of future construction programs, and credit ratios. Those G&T's capable of attaining an AA rating would incur interest costs similar to (3) above to which would be added the indirect cost of securing that quality rating. Attainment or retention of AA rating under a scenario of a reduced REA guarantee program for G&T's with major construction programs and capital requirements would be very difficult without imposition of costly financial standards.

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[1] In addition to the financing alternatives shown here, other alternatives (lease financing, tax-exempt financing, project financing, commercial paper, and bank credit) must be tailored to the transaction and priced accordingly.

[2] Potential rate penalties for initial offerings, for illustrative purpose only.

[3] AA ratings have been obtained by two G&T's for tax-exempt purposes, but we view the BBB to A range as realizable for most G&T's.

[4] Based on a 10.45% yield on 30-year U.S. Treasury bonds. A 15% opportunity cost of members' equity is assumed. The range in indirect costs depends on whether or not equity and reserve requirements are funded from proceeds of debt issues.

[5] For alternatives not funded by the FFB, "long-term" capital could be obtainable at maturities of 20 to 35 years depending on market conditions.

[6] Assumes independent agency. Were lending policies and eligibility requirements of Banks for Cooperatives to change, costs, availability, and spreads over long-term Treasury would be similar for BCs, except that costs of equity would increase total costs by an indeterminate amount.

[7] DSRC is the Debt Service Reserve Certificate purchased with each guarantee. STC is the Subordinated Term Certificate assumed to be purchased with each guarantee. (Assumptions are based on current CFC policy for tax-exempt financing.)

[8] Assumes a DSR equal to one year's interest ($0.125 per $1 of debt) at an incremental cost of 200 basis points ($0.125×200)=25 basis point indirect cost).

[9] Assumes a DSR of $0.09 per $1 of debt at a 200 basis point opportunity cost and an STC of $0.05 per $1 of debt at an opportunity cost of 450 basis points ($0.09×200)+($0.05×450)=40 basis point indirect cost).

[10] Opportunity cost of DSR as in (h) above plus a 500 basis point opportunity cost (based on the differential between an assumed 15% opportunity cost for consumers and a 10% approximate risk-free earnings rate for the invested equity funds) on an assumed 5% equity base (25 basis points+($0.05×500)=50 basis point indirect cost).

[11] These rankings should be considered within the context of the entire report.

STATEMENT OF THE

POWER AND COMMUNICATION CONTRACTORS ASSOCIATION

by

Mr. Lee W. Hogan

Director and Legislative Committee Chairman

Mr. Chairman and Distinguished Committee Members:

My name is Lee Hogan. I am owner and President of Universal Electric Construction Company, Houston, Texas. I appear today on behalf of the Power and Communication Contractors Association as a member of the Association's Board of Directors, and Chairman of its Legislative Committee. The Power and Communication Contractors Associaton represents a highly specialized, little publicized, segment of the National Construction Industry. Nevertheless, our organization includes 268 corporate members; employs 25,000+ American workers; completes $925,000,000 of construction annually; and, for the past two decades, we have constructed more than 75% of the REA and RTA projects completed in this country.

We want to make it abundantly clear at the onset of this testimony, that we have a direct financial interest in the REA construction program and our testimony is thus prejudiced. However, we feel strongly that our experience with REA since its inception in 1936 gives us a perspective that we can beneficially share with your Committee in the consideration of S.1300.

This legislation, and its companion H.R.3050, present the U. S. Congress with its second opportunity to restructure the REA program in the past decade --- the first being the creation of the revolving fund in 1973. You are now facing three choices:

(1) Abandon the REA program and require member electric and telephone co-ops to repay the revolving fund corpus beginning in 1993 and to finance future construction through private financial sources.

(2) Dissolve the revolving fund and revert to a system of funding REA requirements through annual budget appropriations.

(3) Adopt the modifications to the revolving fund proposed by both NRECA and NTCA as embodied in S.1300.

Although there are clearly variations and permutations on these three options, this delineation accurately identifies the three philosophical approaches available to you.

Our organization strongly supports Option 3 --- S.1300 --- for the following reasons:

(1) The retention of the revolving fund, with rates adjusted to match the cost of borrowing by the fund, will provide a permanent method of funding that will neither increase Federal deficits nor exert upward pressure on interest rates, since the projects involved will be guilt in either

the private or public sector under any of the three options considered.

(2) Environmental, engineering, and easement considerations now men that virtually all electric and telephone projects require two to four years from inception to completion. Such programs are clearly not appropriate for annual budget appropriations that may vary wildly with changes in the economic and political climate.

(3) The standardization of engineering and contractual requirements by the REA has provided, and will continue to provide, lower construction costs to the REA's and RTA's of the Nation. Our Association, which does work for investor owned electric and telephone utilities, municipal systems, and other governmental agencies (Defense Department, Corps of Engineers, and various power authorities), has completed studies showing REA bids average 5-12% below other categories because of REA's superior standards. These savings translate directly into lower utility bills for cooperative members.

Our association has noted with concern the criticism directed at the REA program by the U.S.D.A. Inspector General's office as referred to in the WALL STREET JOURNAL of 9/1/83. Although we would refute most of the conclusions in Audit Report #09613-1-Ch, as transmitted to Administrator Hunter by D. E. Adkisson on May 20, 1983, we have particular expertise relating to Recommendation #5, Section II, Page 4 of that report. Mr. Adkisson's suggestion that only those construction projects anticipated in work plans submitted two years prior to need should be reimbursable with loan funds demonstrates such an appalling ignorance of the functioning of a utility system that it completely destroys the credibility of the entire report. This suggestion totally ignores the inequitable occurrence of national disasters, mineral exploration booms, rapidly conceived industrial loads, and changing growth patterns that simply cannot wait the six to eight months necessary for receiving approval for modified work plans. Fortunately, the men and women of the REA program and member co-ops have exercised better judgement in providing rural utility service to this country for the past 50 years than the Inspector General did in preparing his report.

In summary, Ladies and Gentlemen of the Congress, S.1300 provides you with the opportunity to continue one of the most successful and efficient Federal programs for the last half century, at no cost to the Federal budget, by adopting modifications to the current system which the rural electric and telephone industry has thoughtfully developed prior to the arrival of a crisis. We hope you will share our support of this desirable legislative solution.

ADDITIONAL

STATEMENT OF MR. LEE HOGAN, POWER AND COMMUNICATION CONTRACTORS ASSOCIATION

Before the
Senate Subcommittee on Agricultural Credit and Rural Electrification

Madam Chairman and distinguished Committee members, my name is Lee Hogan, I am Owner and President of Universal Electric

Construction Company of Houston, Texas. I appear today on behalf of the Power and Communication Contractors Association, as a member of the Board of Directors and Chairman of its Legislative Committee. Our Association represents 268 corporate members, employs more than 25,000 trained craftsmen, completes in excess of $900 million dollars of construction annually and for the past two decades, has completed more than 75% of the REA and RTA projects built in this country.

I have previously submitted to your staff, copies of my prepared remarks and would appreciate your consideration in entering my statement in your permanent record. Madam Chairman, with your permission, I would like to use my oral testimony to emphasize the highlights of the prepared text, to comment on recent developments and statements relative to Senate Bill 1300, and to elaborate on the motivations for PCCA's testimony in this hearing.

Our association has followed closely the debate connected with this legislation since it was proposed in the spring of 1983. We were present when it was announced by NRECA and NTCA, we have followed with interest the various statements made by representatives of REA, we testified at the House hearings for HR 3050 and participated in the debate at that time, and have monitored closely the various announcements in the public press including the much publicized articles in the Wall Street Journal and Washington Post. Although the issues involved in this legislation are complex, we believe your committee will be well served to keep the following three facts in mind:

1. REA has worked. Its success is documented by the following:
   - A. In the nearly fifty years of REA existence, rural America has gone from less than 10% of electric and telephone connections to more than 95%.
   - B. Loan repayment by REA coops and RTA coops across the nation has been almost perfect, surpassing any other comparable federal program in existence.
   - C. The standardized technical and legal format developed and adopted by REA has been imitated worldwide and has produced a mobility of contruction forces that our Association has now documented saves REA between 5-9% in construction costs versus comparable construction for investor owned and municipal power associations.

2. REA needs to continue. This fact is evidenced by the following:
   - A. REA electric and telephone coops serve 75% of the area of this country but only 10% of its people, they average 4.7 customers per mile versus 36 per mile for investor owned and 78 per mile for public power associations, they produce $3,400 of annual revenue per mile versus $42,000 for investor and $68,000 for publicly owned.
   - B. Standardization and quality control previously referred to must be preserved if private financing agencies are to have the confidence in the system that they must, in order to transfer increasing portions of the REA debt to the private sector.

3. Senate Bill No. 1300 provides the most effective mechanism ever proposed for continuing the REA program and accomplishing the goals set out in No. 2 above. It does this through three principal mechanisms:

A. It matches interest cost of the revolving fund to interest revenue.
B. It provides a means for private lenders to obtain security for their loans.
C. It capitalizes the existing funds in the REA revolving fund.

Senate Bill 1300 is not free. We have listened to opponents of this legislation who characterize it as a forgiveness of debt which it clearly is not. On the other hand, we have heard over-vigorous proponents suggest that the cost to the federal government will be zero by analyzing such esoteric parameters as the net present value of the discounted cash flows of the principal payments that will not be made. We feel very strongly that these exaggerations and over simplifications do not serve your committee well in this deliberation and prefer to acknowledge that the proposed legislation does have a cost, albeit small, but that that cost is justified by the past, present and future operation of this program.

Finally, I would like to address, in a very direct manner, the charges that have been raised against our Association and similar private groups who testify in favor of federal programs that benefit them but otherwise cry out loudly for reduced government participation and lower interest rates. Some would contend that this apparent incongruity is blatant hypocrisy. I would ask them to consider the following two facts:

1. Government intervention in the credit markets of the country only exerts upward pressure on interest rates to the extent that it finances debt that would not otherwise be incurred. If, for example, the government builds one less MX missile, the credit requirements for the country, as a whole, have been decreased by the cost of that missile. If, however, the REA program refuses to finance a given electrical or telephone facility, that facility will be built and financed by the private sector and the total demands on the credit markets will be unchanged. That distinction is significant and must be kept constantly in mind.

2. Your task this year as Senators in minimizing a deficit nearing $200 billion dollars is to establish priorities. It is a difficult, imprecise and unrewarding task. We sincerely believe that honest testimony, with acknowledged prejudices, by citizens participating on a daily basis in the various programs you must consider, is your best source of information in making these difficult decisions. Our testimony is submitted in that spirit. We want to make it abundantly clear that we have a direct financial interest in the REA construction program and our testimony is thus prejudiced. However, we feel strongly that our experience with REA since its conception in 1936, gives us a perspective that we can beneficially share with your committee in the consideration of this legislation.

In summary, ladies and gentlemen, Senate Bill 1300 provides you with the opportunity to continue one of the most successful and efficient federal programs for the last half century at minimum cost to the federal budget by adopting modifications to the current system which the rural electric and telephone industry has thoughtfully developed prior to the arrival of a crisis. We hope you will share our support of this desirable legislative solution.

MAY 15, 1984, HEARING

STATEMENT OF HON. LARRY PRESSLER
A U.S. SENATOR FROM SOUTH DAKOTA

Mr. Chairman, I thank the Committee for allowing me to express my support for S. 1300 and the need to maintain an effective Rural Electrification Program. I also want to commend you for holding these hearings.

As you know, the REA program played a key role in the development of rural America. Electricity changed the lifestyle and management of farms and ranches all across the country. I can still remember when our 160-acre farm near Humboldt, South Dakota first received electric power. It was quite a relief not to use lanterns to milk the cows in the winter or turn the cream separator by hand. Many of these rural areas would not have received electric power if it had not been for the REA program.

Many people say that almost all of rural America now has electricity and telephones, so why do we need the REA program. Well, the job of providing modern services to farmers and ranchers is far from complete. Farming and ranching is constantly becoming more advanced and dependent on modern technology, such as computers. With the slim margin of profit in most commodities, farmers must be as efficient as possible if they are to survive. For this reason, it is essential that we maintain an effective rural telephone and electric system to meet the changing needs of farmers and ranchers.

In regard to S. 1300, I would like to touch on two specific areas. First is the provision for discretionary low interest loans to cooperatives that serve sparsely-populated areas and meet certain other criteria. Many of the cooperatives in South Dakota--in particular, western South Dakota--serve very sparsely-populated areas. These cooperatives fear that if the low interest loans for these areas are left up to the discretion of the REA Administrator, then they will never receive affordable preferential interest rates. I would suggest that the Committee consider modifying this section to protect the interests of these sparsely-populated areas.

A second important issue which this bill addresses is REA's restrictive lien accommodation policies. These policies limit the ability of REA borrowers to obtain non-government financing for improving existing facilities or diversifying operations. Currently, REA holds a first lien on all of a borrower's property, including property subsequently acquired. If the purpose to be financed is one which REA claims it cannot itself finance, REA will negotiate a lien accommodation arrangement if, in exchange, the borrower provides a "compensating benefit", generally in a form of prepayment of existing loans or a reduction in the term of existing notes.

These policies hurt rural consumers. REA would force its borrowers whose loan repayment records are otherwise excellent, to accelerate loan repayments or else be denied access to private market financing. Unfortunately, a number of borrowers have already been placed in this inequitable position and consequently their subscribers have suffered.

In South Dakota, for example, Sanborn Telephone Cooperative courageously sought financial stability by diversifying into cable television. This venture was held up pending negotiations with REA over lien accommodations. After a year and a half, REA agreed to grant the lien accommodations on the new facilities and withdrew its demand for prepayment of REA loans. However, in the interim, the cost of building the cable facility increased due to a rise in interest rates. This resulted in considerably higher cable service bills for consumers. Clearly, in this instance, as in other instances across the country, REA's lien accommodations policies have hurt the very subscribers the agency is mandated to serve.

S. 1300 would rectify the present inequity by requiring REA to grant a lien accommodation when the Administrator determines that the borrower is able to prepay its existing and proposed indebtedness. Thus, the government's security would not be jeopardized in any way; and REA borrowers would be able to obtain additional sources of funding, particularly for necessary financing not available from REA or the Rural Telephone Bank.

Given the uncertainties related to deregulation, reform of REA's lien accommodation policy is all the more important to the survival of small rural telephone systems.

Regarding the costs associated with this legislation, none of the studies which have estimated the bill's cost (all of which vary widely in their estimates) have considered the benefit side of the cost-benefit equation.

S. 1300 calls for increases in the interest rates charged by the Fund to balance its interest income and expenses. The government will realize approximately $7 billion from this additional interest income over the next 25 years, commencing immediately ($5 billion from electric loans and approximately $2 billion from telephone loans). Yet, much discussion has focused on the alleged cost of reclassifying $7.9 billion in notes held by the Treasury to equity capital in the Fund. Assuming this provision was not enacted, however, repayment of the Treasury notes would not commence until 1993; the last of these notes would not be due until 2016—over 30 years from now. Thus, the government would be in a far better situation under S. 1300 than without it—contrary to the implications of the bill's critics.

Overall, the benefits and importance of this well thought-out legislation should not be taken for granted. Rural America needs the REA programs and S. 1300 will ensure their continuation.

STATEMENT OF HON. DALE BUMPERS
A U.S. SENATOR FROM ARKANSAS

I want to thank the members of the Subcommittee on Agricultural Credit and Rural Electrification for holding hearings on S. 1300. The Senate must act quickly on the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act to guarantee continued electric and telephone service for rural Americans at affordable prices.

In its almost fifty years of existence, the Rural Electric Administration has fulfilled its mission of providing electric and telephone service to rural Americans and has done so more efficiently than anyone would have imagined possible in 1936. Rural farmers and families have clearly enjoyed the conveniences of electric and telephone service, but the whole nation has benefited from the increased productivity of American farmers and their contribution to the economic vitality of the nation. The REA directly reaches 25 million people in rural America and 260,000 Arkansas families, but its services benefit every American in some way.

Rural electric cooperatives face the high costs of providing service in areas of low population density. Although the REA has dealt with this problem well, the solvency of the Rural Electric and Telephone Revolving Fund administered by the REA is in jeopardy because of high interest rates of recent years. Congressional action is necessary now to ensure the solvency of the Revolving Fund and the availability of affordable telephone and electric service for rural Americans. If S. 1300 is not approved, the American farmer may face a crisis that will affect the whole nation.

S. 1300 would amend the Rural Electrification Act to ensure the financial integritiy of the Revolving Fund by allowing the REA administration to adjust interest rates on REA loans to ensure that interest income balances interest expenses; converting Treasury notes that would fall due between 1993 and 2017 into equity capital for the revolving fund; and providing for lien subordination or accommodation to assist in obtaining commercial loans. I am proud to be a cosponsor of this measure, and I urge my colleagues to enact it. Rural Americans must have adequate and affordable power, and S. 1300 will help REA continue its fine record in providing that service.

STATEMENT OF ANTHONY J. GABRIEL, DEPUTY INSPECTOR GENERAL
UNITED STATES DEPARTMENT OF AGRICULTURE

Madam Chairman, members of the committee, I appreciate the opportunity to appear before you today to discuss audits the Office of Inspector General has made of the Rural Electrification Administration (REA).

ELECTRIC DISTRIBUTION COOPERATIVES

OIG's two audits of Electric Distribution Cooperatives centered on: The financial condition of the revolving fund; REA's loan-making policies; and REA's controls over borrowers' receipt and use of loan funds.

We found that:

-- Revolving fund assets are diminishing and will need to be supplemented unless interest rates charged to borrowers are increased and loan-making criteria are changed;

-- REA made loans to electric cooperatives which had sufficient financial strength to obtain funding without subsidized interest rates and to borrowers which serviced areas that were no longer basically rural in characteristic;

-- Some cooperatives used loan funds for purposes not authorized by REA; and

-- Controls were not in place to preclude the premature drawdowns of subsidized loan funds which we found were deposited in high interest-bearing accounts.

FINANCIAL CONDITION OF THE REVOLVING FUND

On May 11, 1973, Congress amended the Rural Electrification Act to create a revolving fund for insured loans to electric distribution and telephone borrowers. Treasury created the $7.86 billion revolving fund by twice issuing to REA interest-free notes, once in 1973 and again in 1977, in exchange for outstanding notes on a dollar-for-dollar basis. Repayment of the notes is scheduled for 1993 through 2017. Monies for insured loans were available from the revolving funds' receipts (borrowers' payments of interest and principal) and through sale of the fund's assets (borrowers' loan notes), in the form of Certificates of Beneficial Ownership (CBO), to the Federal Financing Bank.

From the fund's inception in 1973, loan disbursements exceeded incoming revenue. In 1976 REA began selling Certificates of Beneficial Ownership (CBOs) to obtain additional funds to loan and thus began incurring interest expense. To date, assets of $3.31 billion have been sold bearing interest rates up to 15.325 percent. REA also borrowed funds from Treasury for short terms, with interest rates as high as 16.375 percent, to partly pay interest expenses on the CBO sales. At the time of our audit, REA determined through computer modeling that the revolving fund interest expense will exceed interest income by the second half of Fiscal Year 1985. Appropriations will be needed to cover the shortfall, or additional assets would need to be sold. If the trend continues, which is expected because of the rates charged borrowers of 2 and 5 percent, all of the fund's assets will be sold by the year 2004.

First-year appropriations of $1.6 billion would be needed to continue the insured loan program. Beginning with 1993, REA must begin repaying Treasury's interest-free loan which will further compound the fund's problem.

Because of these shortfalls, we recommended that REA seek legislative authority to increase borrower interest rates up to the cost of Government borrowing. We also recommended that the increase in loan interest rates be based on the borrower's financial condition as opposed to the present flat rate.

On April 11, 1984, the Secretary of Agriculture asked the Congress to consider a draft bill "to amend the Rural Electrification Act of 1936 to ensure the continued financial integrity of the Rural Electrification and Telephone Revolving Fund and for other objectives." The draft bill is intended to maintain the revolving fund by raising the interest rate to not less than the Treasury rate for similar obligations plus an amount to cover administrative costs and probable losses of the insured loan program. The bill would also raise the floor on special rate loans from 2 percent to one-half the standard rate or 5 percent, whichever is greater. This provision would require the Administrator to find both extreme financial hardship and substantial rate disparity to approve loans at the special rate.

Our one audit report also explored other financing alternatives. We recommended, as an alternative, that REA institute a loan guarantee program through commercial sources to provide a loan source to financially strong cooperatives that can afford higher interest rates. We estimate that interest savings from a loan guarantee program, versus a direct loan program, could amount to as much as $64 million in the first year. Projected over the 35-year life of REA electric loans, the present value of these interest savings (discounted at 12 percent) would be about $508 million.

REA believes that commercial lenders are willing to make financing available without Government guarantees and will pursue this course of action.

COOPERATIVES SERVING NONRURAL AREAS

The Rural Electrification Act defines rural areas as those not included within the boundaries of any city, village, or borough having a population in excess of 1,500 inhabitants. However, the Act did not contain provisions for limiting borrower participation where the population of the area served had significantly increased.

We found that 54 cooperatives currently served areas where 50 percent or more of the consumers resided in a Standard Metropolitan Statistical Area (SMSA). An SMSA is defined as having one or more central counties containing an urbanized area with at least 50,000 inhabitants. These 54 cooperatives received REA-subsidized loan funds totaling about $600 million from 1979 through 1982. For example, five of these cooperatives are located around a major city with over 80 percent of the consumers residing within the major city's SMSA. We recommended that REA seek legislation to redefine eligible rural areas that would account for later significant changes in population patterns.

The Department's proposed bill submitted by the Secretary of Agriculture on April 11 would give the Administrator more latitude to target funds to rural areas. It would restrict loans for borrowers with a high line density. "High density" would be defined as ten or more consumers or subscribers per mile and is designed to address the urbanized area issue.

FINANCIALLY STRONG COOPERATIVES

We determined that 110 cooperatives had sufficient financial strength and may be able to obtain nonsubsidized credit. Between 1979 and 1982 these cooperatives received subsidized loan funds totaling $106.2 million. The finanical positions of the cooperatives were compared to investor-owned utilities whose service areas were adjacent to those of the cooperatives. Our conclusion was that the 110 cooperatives had more favorable financial positions and appeared capable of obtaining unsubsidized credit. The use of unsubsidized credit would not result in significant increases of the retail electric rates charged to consumers. We recommended REA seek legislative authority to change loan-making criteria and eliminate Federal funding to financially sound cooperatives.

The Department's draft bill would provide greater discretion to the Administrator to determine ratios and criteria for supplemental financing.

LOAN FUNDS USED FOR UNAPPROVED PURPOSES

REA requires that a cooperative's general funds must fall below a specific level before a loan advance can be made so that cooperatives can pay for construction with excess general funds before requesting loan advances. REA controls were not adequate to identify noncompliance with loan drawdown requirements. We statistically projected that REA advanced approximately $254 million to cooperatives which was either premature or not needed. We estimated that for each month the cooperatives gained premature access to loan funds, the Government incurred interest costs of approximately $1.2 million. We identified cooperatives which acquired premature or unnecessary loan advances totaling $44 million of which over $33 million was invested in high yield certificates for periods of 90 days or more and at terms of up to 20.75 percent. We also found that funds were used to pay for work not included in the construction plans approved by REA at the time of loan approval.

REA has drafted proposed rule changes to better control the advance of funds, and for the recovery of loan funds advanced for unapproved construction. REA anticipates publication of these rules in the near future.

TELEPHONE BORROWERS

We are currently conducting an audit of the Telephone Loan Program and the Rural Telephone Bank. The issues identified to date closely parallel those disclosed during our audits of Electric Distribution Cooperatives.

BORROWERS ARE NOT INDEPENDENT

As of December 31, 1983, the REA had loaned about $2.4 billion to 227 borrowers which are owned and controlled by 39 parent organizations.

The parent companies are able to adjust the subsidiary borrowers' financial conditions to qualify for low interest loans from REA. Primarily, this is done by the systematic payment of dividends and other distribution of capital to the parent company and through inter-company transactions. We have found one instance where a borrower paid dividends of up to 130 percent of net income in 1 year to the parent company. Some holding organizations have set up central cash pools for handling general funds of their subsidiaries. The general funds are managed by the parent company in such a manner that the funds are kept at a level where the borrower qualifies for loan advances.

PAYMENT OF DIVIDENDS AIDS CONTINUED ELIGIBILITY

Under REA guidelines, REA borrowers still qualify for low interest loans when paying out equity in dividends (up to 60 percent of total net earnings or margins). The payment of dividends indicates a financially healthy company. With REA borrower telephone companies the payment of dividends helps keep the borrower from exceeding eligibility criteria for continued low interest REA and Rural Telephone Bank financing.

RURAL AREA DESIGNATION

Early results of our audit indicate that loan funds are being used to benefit urban areas. For example, one borrower received an initial loan from REA in 1957 when the corporate limits were less than 1 square mile. Presently, the corporate limits consist of about 18 square miles and contain business centers and viable subdivisions.

In another case, the borrower's projections showed an 829 percent increase in rural subscribers over a 5-year period. Indications are that large amounts of loan funds were used to develop services in 10 municipal areas with populations ranging from 3,766 to 105,252.

Madam Chairman, this concludes my remarks. Thank you.

STATEMENT OF JOHN E. HORNE, EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER, THE FLORIDA RURAL ELECTRIC COOPERATIVE ASSOCIATION

Madam Chairman and members of the Committee:

My name is John E. Horne. I am the Executive Vice President of the Florida Rural Electric Cooperative Association, an association of the 16 rural electric distribution cooperatives in Florida as well as 2 G&T cooperatives.

The 16 distribution cooperatives in Florida, as of 12/31/83, serve 492,917 members, requiring over 46,567 miles of power lines. This represents about 1.5 million people--between 10-11 percent of Florida's population. This 10% of the people we serve are scattered over about 65% of the land mass of Florida.

There is probably more diversity as to the characteristics of the cooperatives serving in Florida than is found in most other areas. For example, the number of members served by these cooperatives ranges from 6,536, the smallest, to 83,885. The number of members served per mile of distribution line ranges from a low of 3.9 to as high as 33. The average number of members served per mile of line is 10.5. This compares to a density of 61 for the IOUs in Florida, and 73 for the municipally-owned utilities.

Florida is one of the nations fastest growing states and is presently the 7th most populated, with a 1982 population in excess of 10.3 million. Its population from 1970 to 1980 increased by 43.5%. By 1990, Florida is estimated to reach a population of 12.3 million persons.

Most of this growth will come from retired persons moving into the state from other areas. A large majority of them will be senior citizens, living on retirement and social security--limited fixed incomes.

A part of the growth in Florida that has occurred over the past 10-15 years has occurred in the service areas of several of the electric cooperatives. For example, the number of members served by Withlacoochee River Electric Cooperative, whose service area lies north and west of Tampa, has increased from 33 to 83 thousand in the last 10 years. Lee County Electric, whose headquarters is in North Ft. Myers has experienced a similar rate of growth, as has, to a lesser extent, Sumter Electric, located south of Ocala and Clay Electric, located in the northwest section of the state.

In each case, however, where this rapid growth has occurred, it has been confined to a relatively small geographic area within the larger, rural areas served by the cooperative, and all of this growth has occurred in areas that had been served by the cooperative, continuously, for over 40 years. All of this growth occurred in areas where the cooperative was the only supplier of electric energy.

In order to serve the demand for electricity brought about by this influx of people, the cooperatives in those areas have had to borrow increasingly large amounts of money for construction and reconstruction of power lines and other equipment. This has had to be done in a period of high and inflated costs. It has resulted in increased average investment per consumer--as compared to utilities with slow or moderate growth. Because of these increased costs, accompanied with increased interest rates since 1973, it has been necessary to increase electric rates and has made it more difficult to maintain a satisfactory equity position for the cooperative.

Following is an example of the actual figures of two cooperatives in Florida--one that has grown at a moderate rate and one that has been located in an especially fast growing area.

	Coop #1	Coop #2
No. of Members	1973- 33,746 1983- 83,855	1973- 8,271 1983- 13,301
Plant Investment	1973- $35 million 1983- $110 million	1973- $8.5 million 1983- $13.2 million
Investment Per Member	1973- $1,049 1983- $1,314	1973- $1,035 1983- $995
Total Interest Expense	1973- $645,000 1983- $3,901,000	1973- $92,021 1983- $295,444
Annual Interest Expense Per Member	1973- $19.00 1983- $47.00	1973- $11.13 1983- $22.21

As can be seen from this, in co-op #1, whose membership increased by 2.5 times, the investment in plant per consumer increased by one-fourth, whereas co-op #2's (moderate growth) investment per consumer actually declined during the period. Similarly, the total interest expense of co-op #1 increased by 6 times, or by nearly double the rate of that of co-op #2. The resulting annual interest expense per member increased from $19 to $47 for co-op #1, more than double that of co-op #2.

Therefore, these data demonstrate that cooperatives in faster growing areas may have a greater need for stable and reasonable interest rate financing than those in static areas.

In addition to the 16 electric cooperatives, 6 investor-owned, as well as 35 municipally-owned electric utilities serve in Florida. The IOUs and municipally-owned systems serve between 89 and 90 percent of Florida's population. The cooperatives serve the balance, most of which are in areas that are most expensive and difficult to serve. Over 46,000 miles of distribution line are required for the cooperatives to serve 10% of the population, whereas the remaining 90% is served over a total of only 70,000 miles of line.

Electric rates in Florida, since 1972, have increased drastically, for all segments of the industry, due in large measure to the growth experienced in the area, and the accompanying increases in costs of materials and supplies, increased need for capital at higher interest rates and increased generation capacity which has had to be constructed at today's costs.

Rate increases for the cooperatives, however, have been at a more rapid rate than for other segments of the industry. For example, the cost of wholesale power purchased by the cooperatives from the IOUs has increased from $.008 in 1972 to as much as $.065 today, an increase of approximately 800%. Retail rates for IOUs, by contrast, have increased from around $20 per 1000 KWH in 1972 to $75 per 1000 KWH now--an increase of only about 475%. Presently, rates for most of the electric cooperatives in Florida are as much as $20 per 1000 KHW higher than the cost of 1000 KWH from one of the IOUs.

Uncle Sam has, and is now, providing assistance, in one form or another to each of these three types of utilities. While no one seems to wish to talk about this, we know that the total of tax incentives afforded to the 4 largest IOUs in Florida during 1982, in the form of investment tax credits and accelerated depreciation amounted to $106,308,109. The accumulated total of these tax incentives, through 1982, amounts to nearly $2 billion, in Florida alone.

By contrast, the total of loans made by REA to the distribution cooperatives in Florida from 1935 through 1983, is $429,503,282. Of this amount, $217,842,633 has been repaid ($104,473,230 on Principal and $113,369,403 in interest).

Without debating the merits of providing tax incentives to the private utility sector, it does seem strange that so much attention has centered around that form of assistance provided through REA to the rural segment of the utility industry when so little has been said of the assistance provided the other segments of the industry.

Madam Chairman, we need this bill to be passed. It will stabilize the revolving fund and will assure a continued source of loan funds for the rural segment of the utility industry. It will not require additional cash outlay by treasury. No one else really wants to do the job that Rural Electrics are doing. You need to give us the tools to continue to do this job right. S.1300 is that tool.

I appreciate the opportunity to present this information to your committee and will be happy to respond to any questions. Thank you.

Federal Assistance to Investor Owned Utilities, 1982

	Florida Power Corporation	Florida Power & Light Comp.	Gulf Power Company	Tampa Electric Co.
Investment Tax Credit	30,260,173	79,125,707	3,555,397	14,165,860
Accelerated Depreciation	8,032,009	48,015,144	10,440,056	12,713,763
Total Amount	38,292,182	127,140,851	13,995,453	26,879,623

Source: Financial Statistics of Selected Electric Utilities 1982, DOE/EIA-0437(82)

STATEMENT OF DR. WILLIAM ORZECHOWSKI, DIRECTOR FEDERAL BUDGET POLICY, CHAMBER OF COMMERCE OF THE UNITED STATES

I am Dr. William Orzechowski, Director of Federal Budget Policy for the Chamber of Commerce of the United States. On behalf of the Chamber's nearly 200,000 businesses, trade associations, and local and state chambers, I welcome this opportunity to express our opposition to the Rural Electrification and Telephone Fund Self-Sufficiency Act (S. 1300), which would temporarily resolve the short-term solvency dilemma of the Rural Electrification Administration (REA) revolving fund at substantial cost to the U.S. Treasury and taxpayer. Recent Congressional Budget Office analyses estimate additional budget deficits through the year 2010 in excess of $ 10.4 billion if this legislation is enacted.

A careful review of REA loan activities has become particularly important, given the burgeoning growth of off-budget activities which drain scarce resources from credit markets. This growth has led to intense competition between private investors and government agencies for scarce capital resources. The Chamber has frequently expressed its dissatisfaction with the lack of formal budget restraint regarding these programs and has urged Congress to reform these programs and the budget procedures which control them. During the last seven years, off-budget programs have grown three times faster than direct on-budget spending. From 1976 to 1983, budget outlays rose 122% while net federal loans, loan guarantees, and credit advances increased 387%.

The Chamber sees a great need for a systematic review of programs operating off-budget. Only in this way, can total government intrusion into the private sector be minimized and excessively generous or unnecessary programs be reformed or discontinued. The current financial and operating difficulties of the REA present Congress with an excellent opportunity to reconsider one of the largest off-budget credit programs.

The increasing popularity of back-door financing has reached an alarming level. Off-budget activities, such as the REA, have escaped the scrutiny of Congressional appropriations procedures by acquiring funds through the Treasury's off-budget subsidiary, the Federal Financing Bank (FFB). In fact, the FFB accounted for 96% of all off-budget outlays from 1978-83.

The REA revolving fund has found the FFB receptive to its need for funds. Special financial arrangements have been developed whereby the fund may pledge its outstanding loan assets as collateral in return for FFB loans at 1/8 % above the Treasury cost of borrowing. These financial vehicles have been termed Certificates of Beneficial Ownership (CBO). Rural electric borrowers comprise the largest recipient group of guaranteed loans issued by the FFB (41%) and they form the second largest recipient group for asset-based loans (CBO's).

To evaluate properly the merits of any legislation seeking to reform budgetary treatment of the REA, the Chamber recommends that Congress ask the following questions.

What is the definition of the program's original mission, and has that mission been effectively and efficiently accomplished? If the initial goals have been attained, should termination or modification be sought? If the program has failed to accomplish anticipated goals, what caused the shortfall? What are the prospects for future attainment of program goals?

At what cost will program goals be realized? Will this cost be justified by sufficient benefits?

Is there justification for government oversight, supervision, administration, preferential treatment, and/or subsidization? Could the private sector fulfill some or all of the program's mission, thereby reducing governmental intrusion into affairs which do not require government imposed solutions?

These questions form a basic outline for the evaluation of any program, on- or off-budget. This pattern of reasoning is easily applied to the REA. With answers to these questions, a rational and sensible decision may be reached regarding pending legislation.

REA MISSION

The REA was established in 1935 to provide financing for the development of electric service to rural America. Later, this mission was extended to include telephone service. In addition, the program was aimed at providing jobs during the Great Depression. The original legislation contained a sunset provision which was to take effect in 1946.

It should be noted that the original legislation never entailed a subsidy for interest rates on loans processed through the REA. Furthermore, past Congressional action also does not reflect a deliberate attempt to subsidize interest rates. In each instance where Congress has reset the applicable REA interest rate, the new rate has been pegged approximately equivalent to the prevailing cost of government funds. The intent of this legislation clearly was to provide availability of funds; not artificially low-cost funds.

Once the economy had recovered from the Depression, the full purpose of the REA was to participate in the financing of rural electrification. By most standards, the program was a success during its early years. During the ten years (1936-46) of scheduled life for the REA, the percentage of farms receiving electricity had increased from 11.6% to nearly 34%. The program was extended, and by the early 1950's, over 90% of all farms were receiving electricity. In 1964, 98% of farms had access to reasonably priced electric service. The last twenty years, however, have seen only minimal advances in rural electrification; as the percentage of serviced farms rose only 1%, from 98% to 99%.

It appears that the REA had fulfilled its original mandate by the mid- 1960's, yet it continues to operate as one of the largest off-budget entities. Additionally, the REA administers some of the most handsome interest rate subsidies available. It is quite distressing to note that in the ten year period, 1973 to 1983, federal lending to REA borrowers rose 760%, while total rural electric co-op customers rose only 32%, and newly electrified farms have grown only 0.2%.

Careful analysis of Congress' original intentions reveals that the REA was established as a lender of last resort for financing the electrification of rural America. The subsidization of interest rates was never intended. The current situation of highly subsidized borrowing costs is an accident of history combined with a lapse in Congressional oversight. It is ironic that rural electric co-ops are receiving a greater subsidy at a time when the REA mission is mostly completed. No subsidy of this magnitude accompanied the program during its most important phase, the early years.

Historically, the rates on REA loans were established near or slightly above the Treasury's prevailing cost of funds. At present, REA administered loans are issued at 5%; whereas, Treasury borrowing costs rest at 11 percent. The disparity between the Treasury's cost and the REA's cost occurs because REA lending rates have been pegged by statute without provision for periods of increasing interest rates. Thus, the REA borrowers are benefiting from a legislative inefficiency which has failed to readjust the rate on loanable funds.

Despite current REA practices, there is no evidence to suggest that interest subsidies were intended to be an integral part of its mission. The REA seems to have interpreted its primary goal as provider of artificially low cost funds, even though there is no precedent and little direct justification for such actions.

COSTS VERSUS BENEFITS

Currently, the REA is offering loans to rural electric co-ops at rates of 2% and 5%, while market rates for similar risk-class borrowers have averaged above 14% in the recent past. The stated purpose of these loans is to aid in the development and maintenance of electric service to low density population areas.

The costs of this program extend beyond the level of subsidies granted through lending rates far below those available from comparable private sources. The program's costs also include administrative expenses; the costs of crowding out private investment; the costs to the Treasury from tax-exempt status; and the reduced incentives for co-ops to seek independence from government supported financing.

In addition to these costs are the sunk costs of previous bailout schemes for the REA revolving fund. The 1973 Congressional package granted an exemption from the repayment of accumulated interest on outstanding debt (worth over $ 370 million) and all future interest which would have been required to service the debt until retirement (worth $307 million per year); deferred the principal repayment schedule by 20 years, thereby substantially reducing the present value of debt service; and pegged the rates on REA administered loans at 5 percent. In light of present bailout schemes which seek massive aid and concessions, rather than serious reforms which would restore long-run solvency, it is interesting to note that the 1973 legislation specifically attempted to ensure the REA revolving fund's self-sufficiency and independence without extensive additional Federal aid.

The major benefit from maintaining the REA's favorable budget status would be for hardship cases where a co-op might face severe difficulties in continuing its operations and where private financiers are unwilling to undertake the risk associated with hard-pressed co-ops. Since there appears to be substantial private interest in rural electrification projects, the REA mission could be tailored to the aid of hardship cases while encouraging the active participation of private lenders in non-hardship situations.

It is not so much the interest subsidy that has been beneficial to needy co-ops, but the availability of funds. According to the Congressional Research Service (CRS), the average co-op consumer gains only 15 cents per month for every 1% reduction in borrowing rates. The present interest subsidy offered by the Treasury of approximately 6% amounts to a savings of only 75 cents per month for the average ratepayer. The interest savings from availability of Federal funds below equivalent market rates (5% versus 14%) results in only $1.35 electric rate savings per month for the average consumer.

The Inspector General's Audit Report and a General Accounting Office (GAO) report conclude that many cooperatives could obtain outside financing from private sources. The additional interest cost associated with this financing has been shown to have minimal effects upon the average co-op consumer. Of 50 co-ops selected in the Inspector General's report, 44 were found to be in a stronger financial position than neighboring investor owned utilities (IOU). For 37 of the 50 co-ops, increased cost of borrowing equal to the Treasury's borrowing cost had negligible effects upon the retail electric rates charged. In fact, over 45% of REA cooperatives would still be able to maintain retail rates lower than those of comparable investor owned utilities, if required to borrow at the Treasury's own cost of funds.

There are other costs to an administratively operated program, namely inefficiency and abuse. A recent GAO audit report suggests some mismanagement of REA funds at the co-op level does occur. Three examples of the abuses cited in the loan program are listed below.

- Unnecessary loan advances of $44 million were issued
- $ 70 million disbursed to co-ops for unapproved projects
- 22 co-ops used part or all REA of loan proceeds, acquired at 2% and 5%, for reinvestment in marketable securities yielding up to 21%

Inefficiency may be illustrated by the changing nature of the rural electric business versus the static provisions of REA regulations. The number of customers in the servicing areas of co-ops has consistently risen, thus transforming many rural areas into small urban communities. As of 1981, 36% of "rural" electric co-ops served customer bases in excess of 10,000 consumers. The Inspector General's report also found 34 co-ops out of a judgement sample of 38 to be within 50 miles of a major urban center. One of these co-ops, which was located in the Washington, D.C. suburbs, serviced a population whose median income was over $25,000, 22% above the national average.

As a result of rural and suburban growth, the typical co-op service area has changed from being mostly farms to becoming increasingly commercial and residential. Despite the changing profile of many co-ops, there is still open access to subsidized financing, which was intended for strictly rural electrification.

FISCAL DISCIPLINE AND CURRENT PROPOSALS

An appropriate resolution to the REA problem centers on achieving an interest rate for REA loans that will provide sufficient inflows of cash, through debt repayment and interest payments, so that the fund may continue to advance new loans and service its own debt to the Treasury. The problem is not difficult to resolve. By correcting the negative spread of rates between the cost of REA funds, especially the CBO's, which carry an average cost of 11.5%, and the lending returns from loans to co-ops, now at 2% and 5%, the revolving fund could restore itself to long-term solvency.

The current debate focuses on raising the average rate on REA loans to co-ops as a means of attaining an equilibrium where solvency and self-sufficiency will exist through the long term. Implicit in the Chamber's arguments, and those in Congress, is the desirability of maintaining a financing pool independently capable of servicing rural co-op needs with minimal government assistance.

However, rather than making the necessary adjustment to interest rates, the new legislation, as written, would constitute a giveaway of $7.9 billion by "forgiving" the outstanding debt, and all associated interest. The GAO has estimated the value of forgiven interest at $9.8 billion , in present value terms, thereby yielding a benefit in excess of $15 billion.

There would also be a provision for downward refinancing of existing CBO's if Treasury borrowing costs should fall below the agreed rate on previously issued CBO's. There is no provision for a parallel upward revision, thus exposing the Treasury to the prospect of eventually funding all CBO's at the lowest prevailing rate in the future. This is similar to interest subsidization since the Treasury will have to bear the negative rate spread if future rates on CBO loans are established and refinanced at levels less than the average long-term cost of government funds. Depending on the level of borrowing and future interest rates, this provision could cost several billion dollars.

As a further bonus to the revolving fund, there is a stipulation in pending bills which would allow the CBO debt to be rolled over at maturity. Effectively, this makes permanent the $ 3.5 billion acquired through this source.

The popularity of present legislation seems based upon the belief that a reduction in REA expenses, by allowing default on its massive debt, would provide solvency. Though expenses will be curtailed substantially, the standard rate formulation will be altered to allow only minimal upward adjustment in loan rates. Empirical evidence supplied by the Congressional Research Service indicates that the rates under the proposed formula will not be sufficient to ensure solvency, even with the costly bailout provisions presently proposed.

The necessary average rate would have to be a minimum of approximately 8.75% (according to GAO estimates), in order to be minimally certain of future success. The proposed formula would result in a rate nearly 3% below this breakeven point. Estimates from GAO, CRS, and the Congressional Budget Office predict insolvency as early as 1990, and bankruptcy as early as the year 2000, even with the bailout features.

Clearly the critical factor is achieving a fiscally responsible lending rate. Representative Bethune (R-AK) proposed such an amendment featuring a revised standard rate formulation which would phase-in a lending rate more reflective of market conditions. The long-run average Bethune rate would approximate the 8.75% break-even figure, but still average below the government's cost of funds. The most attractive aspect of the Bethune amendment is the ability of this new rate formula to achieve solvency while affording, and requiring, repayment of all debt. Any fiscally responsible plan must be modelled along these lines.

SUMMARY

The Chamber strongly supports a Bethune-type proposal. Any action which would achieve the two goals of solvency and self-sufficiency, as well as complete fulfillment of debt obligations, is to be commended. It makes little sense for Congress to authorize a bailout which CBO estimated could cost over $ 10 billion by the year 2010.

The Senate should consider a proposal similar to Representative Bethune's by which everyone gains. The Treasury and taxpayer would be repaid their $ 7.9 billion in loans, as well as the $ 3.5 billion in CBO's. The consumer and co-op would gain through the continued solvency of the revolving fund, thereby assuring a source of easily accessible financing for REA projects. The private lender gains by becoming an integral part of new financing (50% of all new financing would be open to private participation). The entire economy would also be a winner since free market forces would provide an efficient allocation of resources and fair compensation to all associated resource suppliers.

If the intent of present legislative deliberations is to stave off eventual bankruptcy, and provide for stable financial planning, then the Bethune amendment should be considered. Besides placing the fund on secure foundations, the Bethune formula for standard rate determination would stabilize rates at only 3 to 4 percent above current subsidized rates. As any financier is aware, a stable certain rate is invariably worth a premium. This is one often overlooked advantage of the Bethune formula. The CRS models also indicate that lower rates, and less volatile rates result using the Bethune formula in the long term.

STATEMENT OF BAKER A. SMITH, EXECUTIVE VICE PRESIDENT UNITED STATES BUSINESS AND INDUSTRIAL COUNCIL

Madame Chairman and the Members of this Subcommittee: My name is Baker A. Smith. I am executive vice president of the United States Business and Industrial Council (USBIC). USBIC is one of America's oldest business organizations. Founded in 1933, the USBIC represents several thousand senior corporate executives from a wide range of business and industry nationwide. USBIC members share a dedicated commitment to our free enterprise system.

I welcome this opportunity to express the Council's views on S.1300 - The Rural Electrification Revolving Fund Self-Sufficiency Act of 1983. The proponents of this legislation are claiming that its prompt passage is necessary to forestall the involvency of this program. Indeed, this case was successfully impressed on the House of Representatives which passed - with little thoughtful consideration - companion legislation earlier this year.

USBIC is pleased, however, that this legislaion is being given proper attention in your committee, Madame Chairman. If we listen to those who urge Congress to take a long, careful look at the provisions of this bill, it becomes clear that passage of the bill is anything but warranted. On the one hand, the National Rural Electric Cooperative Association (NRECA) - a special interet group - would have us believe that passage of S.1300 is needed to keep the lights on in rural America. On the other hand, your committee has already heard from a number of considerably more impartial and credible officials - from such agencies and departments as the Congressional Budget Office, General Accounting Office, Department of Agriculture, Department of Treasury, Congressional Research Service, Office of Management and Budget - each stressing that, at the very least, we need to carefully review the ramifications of this legislation.

I wish to emphasize at the outset, that USBIC acknowledges the significant job which REA has performed in bringing electricity and power to rural America. We have many members who can proudly be called self made individuals: people of very humble origins from rural areas without even the benefit of running water let alone electricity. I am sure these members could provide convincing testaments to the fine work of the REA.

USBIC represents many members from rural America. We have a significant constituency of agricultural and agribusiness members - the types of people that the NRECA wants us to believe are solidly behind this bill. This is certainly not the case, however, with our members Madame Chairman.

USBIC, in fact, bases its opposition to S.1300, on a detailed study which our Advisory Task Force on Agriculture recently made of this issue. In March of this year our Task Force published a comprehensive, 83-page report, "White Paper on Agriculture: The Government on the Farm," which examined in detail the REA and the Revolving Fund. Our White Paper recommended that the legislation under consideration be strongly opposed.

When the REA was established by Congress in the

1930's, Federal support was necessary if rural American was to have electric power. The original purpose of the REA Act, however, has long been achieved. Today, about 95 percent of households in rural areas have telephone service. The percentage of farmers receiving central station electricity increased from 12 percent in 1935 to over 99 percent in 1981.

Madame Chairman, the REA has obviously moved far beyond its original mission. While the number of consumers served by electric cooperatives increased by more than 50 percent since 1970, the number of American farms served has only increased by three tenths of one percent. In other words, most new consumers served by the REA have been rural and suburban households other than farmers.

At the same time, the role of the REA has shifted dramatically from a lender of last resort to a subsidized lenders of first resort.

According to a recent study done by the Congressionsl Research Service, between 1973 (when the Rural Electrification Revolving Fund was established) and 1981, RETRA lending rose by close to 760 percent in a period when the number of consumers served by electric cooperatives increased by 32 percent and the number of U.S. farms receiving electricity rose by two-tenths of one percent.

In prior testimony before your Committee, Mr. William A. Niskanen, a member of the President's Council of Economic Advisors explained how the RETRA's subsidized lending policies has had the effect of insulating one group of consumers from the unpredictability of the marketplace and penalized other consumers.

"The artifically low interest rate that REA borrowers pay induces them to over invest in capital intensive methods of producing power. As a result of this interest subsidy, REA borrowers have an incentive to produce higher cost electricity than otherwise."

Even though this interest subsidy was originally intended for rural residents, it often goes to suburban residents. In an audit prepared by the USDA inspector general, it was found that in one case, a cooperative was serving a clientele in a suburban area whose income was over 20 percent greater than the national median.

The principal effect of this disparity is to force the taxpayer to subsidize the electricity consumption of some of their fellow citizens while these same taxpayers must pay higher prices for their own electricity.

Madame Chairman, as you know, the main objective of S.1300 is to have the Treaasury Department forgive the repayment of $7.9 billion in notes now scheduled for repayment in 1993. This is accomplished by transferring assets, taking the $7.9 billion in assets which are currently committed to Treasury beginning in 1993 and transferring them to the Revolving Fund.

The NRECA characterizes this conversion as a "bookkeeping transfer from one government agency to another." Madame Chairman, let us identify this conversion for what it is. It is a bailout bill, an off-budget credit program that raises U.S. borrrowing/taxing requirements, and further weakens private credit markets.

According to a recent CRS study, S.1300, although not increasing the budget in a "technical sense, has the effect of leaving it indefinitely enlarged by $7.9 billion." Passage of this bill would create a disasterous precedent for future forgiveness under Federal loan programs. In recent years these loan programs have grown at a much faster rate than have the more widely publicized budget outlays Indeed, in recent years, these programs pre-empted an even greater share of domestic credit resources than did the budget deficit.

In our view S.1300 seeks to further distort and extend the original, noble purpose of the REA. It will not, as its proponents purport, insure the insolvency of the RETRA. Instead, what it insures is the preservation of the special interests of the NRECA which is spending considerable amounts of money to pass this bill and perpetuate itself.

On behalf of the U.S. Business and Industrial Council, I urge the Members of this Subcommittee to kill this legislation and to work toward putting the Revolving fund on truly sound footing by increasing the interest rate levels on the loan it extends; and most importantly, to encourage borrowers to look to the private sector for credit.

Thank you.

STATEMENT OF JOE D. PACE, SENIOR VICE PRESIDENT NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC. WASHINGTON, D.C., UNITED STATES OF AMERICA

Introduction

My name is Joe D. Pace. I am an economist and a senior vice president of National Economic Research Associates, Inc. (NERA), a firm of consulting economists with principal offices in Washington, DC, White Plains, NY, and Los Angeles, CA. My educational and professional background is set forth in Appendix I.

I have been asked to appear before you today not to discuss the direct economic impact of S.1300, but instead to address a background issue that has been advanced as key to considering the merits of S.1300. That issue is whether federal subsidies now being provided to investor-owned utilities (IOUs) are greater than those now provided to rural electric cooperatives (coops). If that were found to be the case, S.1300 might be viewed as just one available step to help pull the coops even with the largest sector of the industry.

Over the past several years, the National Rural Electric Cooperative Association (NRECA) has been making precisely such a claim. NRECA's latest study suggests that on a per-customer basis, IOUs receive over five times the federal subsidy received by coops.[1]

During the course of my economic consulting work over the last 15 years, I have analyzed the subsidies received by electric utilities on several occasions. I first published an article on this topic in 1971. In part because of this background, in early 1982, I was asked by NRECA to evaluate its analysis and present my findings at NRECA's National Tax Conference.[2] More recently, I have updated and refined my findings. My research on this topic was financed in part by NRECA and in part by a group of 13 utilities which jointly support research on a wide variety of industry problems.[3] However, the views expressed in my statement are my own. They have not been reviewed by and do not necessarily reflect the position of NRECA or any individual utility.

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[1] Donald E. Smith, "Federal Assistance to Electric Utilities—A Reappraisal," National Rural Electric Cooperative Association, December, 1982.

[2] The results of that analysis are presented in: Joe D. Pace, "The Subsidy (Or Lack Thereof) Received by Cooperative Electric Utilities," National Economic Research Associates, Inc., May, 1982.

[3] The 13 utilities are: Carolina Power & Light Company, General Public Utilities Service Corporation, Houston Lighting & Power Company, Long Island Lighting Company, New England Electric System, Pacific Power & Light Company, Pennsylvania Power & Light Company, Public Service Company of Colorado, Public Service Company of New Mexico, Puget Sound Power & Light Company, San Diego Gas & Electric Company, Virginia Electric & Power Company and Wisconsin Electric Power Company.

In the remainder of this statement, I will discuss the NRECA finding and contrast them with my own. This will be followed by a summary of th key analytical errors that produce the NRECA result and explain why m findings are so different. I will conclude with a few comments on the broa public policy implications of the differential in federal subsidies provided t various sectors of the electric utility industry.

Summary of Relative Subsidy Findings

The most recent NRECA study concludes that in 1981, coops receiv federal subsidies of only $8.91 per coop customer, while the subsidy to IO amounted to $50.70 per IOU customer.[4] Thus, according to NRECA, the IO subsidy was over five times the coop subsidy on a per-customer basis.

It is extremely important to recognize at the outset just what NRECA measuring--its analysis focuses on federal subsidies provided to coops only connection with new insured loans extended to coops in the year 1981. Thus, tells you nothing about the total amount of federal subsidies provided to co in 1981. Beyond this, the NRECA analysis measures only the federal subsi provided in connection with the 1981 loans in a single year. It makes no eff to measure the total subsidy that will be provided as a result of the 1981 lo over the life of those loans. In sum, the NRECA analysis, even if it w correctly done in all other respects, does not measure anything v relevant--it cannot tell you anything about the total amount of fede subsidies provided to coops and IOUs in 1981, nor can it tell you anything ab the increase in federal subsidies that can be expected to result from 1 loans made over the life of those loans.

In sharp contrast to the NRECA study conclusions, my analysis sh that the additional federal subsidies extended in connection with new 1 investments by coops and IOUs can be expected to amount to $47.21 per c customer and to $14.88 per IOU customer during each year of the life of t investments.[5] Thus, I reach virtually the exact opposite of the NR conclusion--that is, that on a per-customer basis, coops received three ti the federal subsidy extended to IOUs in connection with 1981 programs.

I have also analyzed 1983 data to see how the relative subsidy situa may have changed. I find that the additional federal subsidies extende connection with new 1983 coop and IOU investments can be expecte amount to $40.89 per coop customer and $13.72 per IOU customer during year of the life of those investments. Thus, although the gap narrowed sli between 1981 and 1983, there is simply no question that per customer, c continue each year to receive additional federal subsidies far in exce those provided to IOUs.

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[4] Smith, op. cit., p.1.

[5] These calculations are described and provided in Appendix II.

Beyond this, it is extremely important to look at the subsidy measure NRECA never addresses--that is, the total federal subsidy currently being provided to coops and IOUs. Based on data for 1982 (the latest year providing complete information), my analysis shows that as a result of federal programs, coops were provided with subsidies amounting to a net advantage over IOUs of $160 per customer. In sum, there is simply no question that coops continue to enjoy a very sizeable subsidy relative to that provided to IOUs. The NRECA study does not refute this because, as explained above, it does not purport to measure the total federal subsidy flowing to coops and IOUs.

Principal Disagreements with NRECA Subsidy Analysis

This section summarizes the key analytical errors that characterize the NRECA study and explains why my conclusions differ. A detailed explanation of these points is provided in Appendix II.

(1) The NRECA analysis measures only the out-of-pocket costs borne by the federal government in connection with insured loans provided in 1981. For the year ending September 30, 1981, NRECA estimates that the federal government's cost of money was 8.00 percentage points above the interest rate charged to coops for insured loans (a 13.00 percent cost of funds versus 5.00 percent interest rate charged). Essentially, this 8.00 percentage point loss, multiplied by $850 million in insured loan commitments in that year, produces NRECA's coop subsidy measure. This approach attributes no value whatsoever to the additional $4.4 billion of guaranteed loans extended to coops in 1981 by the federal government.

A comprehensive analysis of the relative subsidies provided to coops and IOUs should compare the interest rate paid by coops on all loans received in 1981 with the costs incurred by IOUs to raise capital in 1981. The logic behind this is that because the coops and IOUs are in essentially the same business, if coops had to raise capital in the marketplace rather than receiving the bulk of their funds through government insured and guaranteed loans, the coops could expect to pay at least as much for new capital as do IOUs. The benefit conferred on coops by federal loan programs thus is equal to the difference between their total interest cost and what their capital costs would be at IOU levels. For 1981, this more than doubles the measure of the coop subsidy. (The coops' average interest cost was 12.37 percent in 1981, or 3.41 percentage points less than the IOUs' after-tax capital cost of 15.78 percent. This differential multiplied by the total $5.59 billion financing in 1981 yields an estimated subsidy of $191 million, or $20.49 per coop customer.)

It is worth noting that virtually the entire $191 million subsidy figure can be viewed as a cash loss to the federal government. Instead of extending $5.3 billion in insured and guaranteed loans to coops in 1981 at an average 12.50 percent interest rate, the federal government presumably could have used those same funds to purchase IOU securities yielding an average return of 15.78 percent. The out-of-pocket loss associated with the loan program thus could be viewed as $174 million (15.78%-12.50% x $5.3 billion) or about $19.00 per coop customer.

(2) The NRECA analysis fails to attribute any subsidy to the fact that coops pay no federal income taxes, yet at the same time it treats all reductions in IOU tax liability as an IOU subsidy. The IOU subsidy is measured by the reduction in federal taxes paid resulting from the use of investment tax

credits and accelerated depreciation. To place the analysis on a comparable footing, the coops current zero federal tax costs should be compared with the tax burdens they could be expected to bear if they raised capital in the private marketplace and paid full federal income taxes on the income that would be required to support such private capital raising. Including the effect of taxes not paid by coops raises the coop subsidy calculation to $448 million in 1981, or $48.06 per coop customer. The failure to collect such taxes is a direct cash loss to the federal government.

(3) The NRECA analysis fails in another important respect to produce coop and IOU calculations which are comparable. The coop calculation is produced by looking only at the first year subsidy associated with 1981 loans. In contrast, the IOU subsidy calculation is produced by looking at investment tax credits taken in 1981 plus all taxes deferred in 1981. However, tax deferrals in 1981 result from the cummulative effect of taking accelerated depreciation on IOU investments made in all prior years. To produce a number comparable to the coop subsidy calculation, the first year investment tax credit and deferred tax benefit associated only with 1981 IOU investments must be calculated. When this is done, the IOU subsidy figure is reduced slightly from NRECA's $50.70 per-customer calculation to $45.28 per customer.

Looking at first year subsidies does not provide a reasonable basis for comparison, however. This is because the coop subsidy will persist at essentially the same level during each year of the life of the loans extended in 1981. But, in contrast, the subsidy provided to IOUs in connection with 1981 investments will decline every year and even reverse after year 15. After the first year, there is no investment tax credit to reduce tax liabilities. After the second year, the tax benefits yielded by accelerated depreciation decline continuously. Clearly, it is inappropriate to compare an essentially level annual coop subsidy with the first year of a declining stream of IOU subsidies.

To produce comparable numbers, the relative subsidies can be expressed on a levelized annual basis. When this is done, the coop subsidy is found to be $47.21 per customer, while the IOU subsidy is found to be $14.88 per customer. What this means is that the federal loan programs and tax forgiveness provided to coops in connection with 1981 investments were sufficient to reduce the costs to coops by $47.21 per customer during each of the 35 years of the loan life. Likewise, the tax benefits resulting from the use of accelerated depreciation and investment tax credits are sufficient to reduce the costs to IOUs by $14.88 per customer during each of the assumed 35 years of the life of the 1981 investments.

(4) Finally, as noted above, the NRECA analysis never addresses the total subsidy currently provided to coops and IOUs. My analysis reveals that in 1982 the coops enjoyed a net subsidy advantage of $160 per customer. One hundred and twenty dollars of this resulted from federal government insured and guaranteed loan programs and from the forgiveness of federal income taxes. An additional $40 per-customer subsidy is estimated to have been provided by granting coops preference to low-cost power produced by federal marketing agencies.

The Effects of the Subsidy

Aside from the loss of a relatively small amount of revenue to the U.S. Treasury, what are the effects of the relative subsidies provided to the coops? First, anytime the price of a good or service is subsidized, it will be overconsumed. The net subsidies provided to coops lead to underpricing the electricity they sell. One thing that all electric utilities have learned during the past decade is that even the demand for electricity is responsive to price. If you underprice it, people will overuse it. In an age when so much public policy is directed toward discouraging inefficient use of energy, the effects of all energy subsidies provided by the federal government deserve reconsideration.

Second, my own view long has been that a large part of the antitrust difficulty this industry has experienced in the past decade has been directly attributable to the subsidy. Coops and IOUs have engaged in protracted litigation before the Nuclear Regulatory Commission and, to a lesser extent, before the Federal Energy Regulatory Commission and federal courts, aimed at determining the IOUs' antitrust obligation to coordinate and otherwise share benefits with coops. IOUs naturally have been reluctant to share all of the advantages of scale and coordination with rival coops who have an important competitive edge as a result of federal financing programs. Were the relative subsidy reduced, the antitrust problem might well go away.

Finally, the most recent concern with the subsidy grows out of the debate regarding deregulating electric generation. The view that the generation of electricity is no longer a natural monopoly requiring regulation is being espoused with increasing frequency. This leads to the suggestion that electricity generation should be split off from transmission and distribution and furnished by unregulated competitive companies. But if publicly-owned and cooperative utilities still were free to build generating facilities, and if they were provided with subsidized capital to do so, the deregulators' vision of a competitive generating industry might be translated into a publicly-owned and cooperative monopoly. Thus, the continued provision of significantly unequal subsidies to various sectors of the electric utility industry will present a major stumbling block to further considerations of partially deregulating the industry.

APPENDIX I
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PROFESSIONAL BACKGROUND
OF
JOE D. PACE

February 1984

Present Position

Senior Vice President
National Economic Research Associates, Inc.
1800 M Street, N.W., Suite 600 South
Washington, D.C. 20036

Education

B.A. with Honors in Economics, College of William and Mary, 1966. Phi Beta Kappa.
M.A. in Economics, University of Michigan, 1967.
Ph.D. in Economics, specializing in industrial organization, public utility economics and labor economics, University of Michigan, 1970.

Professional Experience

1968-1969	Instructor, University of Michigan.
Summer 1969	Assistant Planner, Washtenaw County Planning Commission.
February 1970 to Present	National Economic Research Associates, Inc. (NERA). Joined NERA as a senior economist. Subsequently advanced to senior consultant and to vice president. Elected senior vice president in December 1979. Consulting experience in the following industries:

Consulting experience in the following industries:
- Electric Utility Industry
- Telecommunications Industry
- Computer Industry
- Textile Machine Industry
- Other Industries:
  - Consumer Glassware
  - Wholesale Drug Distribution
  - Publication of Petroleum Information
  - Electronic Cash Registers
  - Beef Slaughter and Fabrication

Publications

Pace, Joe D., "Deregulating Electric Generation: An Economist's Perspective," Current Issues In Public Utility Economics, edited by A.L. Danielson and D.R. Kamerschen, Lexington Books, Lexington, MA, 1983.

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Speeches

Pace, Joe D., "The Changing Role of Supply Substitutability In Defining and Measuring Relevant Markets." Speech before the National Economic Research Associates, Inc., Fourth Annual Antitrust Seminar, Aspen, Colorado, July 8-10, 1982.

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____________, "The Subsidy (Or Lack Thereof) Received By Cooperative Electric Utilities." Speech before the National Rural Electric Cooperative Association, 1982 National Tax Conference, Minneapolis, Minnesota, May 25-27, 1982.

____________, "Deregulating Electric Generation: An Economist's Perspective." Speech before the International Association of Energy Economists, Third Annual North American Meeting, Houston, Texas, November 12-13, 1981, Washington, D.C., November 20, 1981.

____________, "Comments Prepared for the California Public Utilities Commission Workshop on Electric Generation Deregulation." Speech before the California Public Utilities Commission Electric Generation Deregulation Workshop, Hastings College of Law, University of California, San Francisco, California, July 30-31, 1981.

____________, "Antitrust and the Electric Utility Industry." Speech before the Edison Electric Institute/Legal Committee, Spring 1981 Meeting, Afton, Oklahoma, April 21-24, 1981.

____________, "An Economist Looks At Price Squeeze." Presentation before the Federal Energy Bar Association, Mid-Year Annual Meeting on Emerging Competitive Rules for Bulk Power Transactions--Price Squeeze and Related Matters, Washington, D.C., January 24, 1980.

____________, "Does Social Ratemaking Make Sense?" Speech before the Indiana University Graduate School of Business sponsored by the Edison Electric Institute Rate Research Committee, Indiana University, Bloomington, Indiana, June 21, 1979.

____________, "Lifeline Rates (An Idea That Sounds Better Than It Is)." Speech before the Western Conference of Public Service Commissioners, Annual Conference, Phoenix, Arizona, May 5, 1976.

____________, "Lifeline Rates: Will They Do The Job?" Speech before the American Public Power Association Services and Communications Workshop, Jacksonville, Florida, September 17, 1975.

____________, "The Poor, the Elderly and the Rising Cost of Energy." Speech before the Pennsylvania State University/Pennsylvania Electric Association, Hershey, Pennsylvania, April 23, 1975.

____________, "Problems in the Measurement and Application of Demand Elasticity to the Electric Utility Industry." Speech before the Executive Enterprises, Inc. Seminar on Current Trends in Public Utility Ratemaking, New York, New York, June 18, 1974.

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Testimony Before State and Regulatory Commissions

Regarding electric utility rate design:

Arizona
Connecticut
Massachusetts
New Jersey
New York
Oregon
Wisconsin
Wyoming
Utah

Regarding electric utility productivity and efficiency:

New Mexico
Federal Power Commission
- o On Behalf of Georgia Power Company

Regarding the application of antitrust principles to electric utilities:

Nuclear Regulatory Commission

- o On Behalf of Alabama Power Company
- o On Behalf of Consumers Power Company
- o On Behalf of Toledo Edison Company and Cleveland Electric Illuminating Company

Federal Energy Regulatory Commission

- o On behalf of Boston Edison Company
- o On behalf of Central Maine Power Company
- o On behalf of Pennsylvania Power Company
- o On behalf of Union Electric Company
- o On behalf of Southern California Edison Company

Testimony Before Legislative Bodies

Regarding combination gas and electric utilities:

Senate Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, U.S. Senate

Regarding electric utility rate design:

Subcommittee on Energy and Power, Committee on Interstate and Foreign Commerce, U.S. House of Representatives

New York State Assembly Committee on Corporations, Authorities and Commissions

Testimony Before United States District Court

In the Matter of the Monfort of Colorado, Inc. v. Cargill, Inc. and Excell Corporation before the U.S. District Court for the District of Colorado, Civil Action No. 83-F-1318, October 1983.

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February 1984

CALCULATING THE SUBSIDY RECEIVED BY IOUS AND COOPS

Definition of the Term "Subsidy"

In this analysis, a subsidy is defined as a grant by a government to a person or company, generally to promote an enterprise deemed advantageous to the public. While a subsidy most often is thought of as a direct cash payment by the government, real benefits can be conferred on selected individuals or companies in other ways. The government may take actions to reduce the risks borne by private companies and so reduce their costs. Examples of this would be granting a franchise which reduces the business risk faced by a company or directly guaranteeing its securities. These actions subsidize the operations of a firm just as effectively as do cash payments. Indeed, the government may even make money at the same time that it confers a subsidy on a firm or industry. As an illustration, if a $500 tax were imposed on every imported automobile, undoubtedly the government would increase its revenue, while subsidizing the domestic automobile industry by artificially propping up prices. In short, subsidies can take a number of forms other than direct cash payments by the government. Anytime the government takes selective action to confer an economic benefit on individuals or firms, whether it involves a direct payment, the assumption of risk, or some other action to raise prices or lower costs, a subsidy has been granted.

A comprehensive analysis of the subsidies provided by various federal government programs should focus on the relative benefits conferred on IOU and coop customers by these programs. While it is certainly not irrelevant to ask what are the costs of these programs, it should be recognized that measuring total costs may be difficult, especially when the programs at issue involve the assumption of substantial market risks by the federal government.

General Approach to Measuring the Subsidy

The government operates through thousands of direct assistance, commodity purchase, tax forgiveness, import-export policy and guarantee programs to confer benefits on individuals and companies in order to stimulate economic activity deemed desirable. In light of this, to try to measure the absolute amount of subsidy received by any particular firm or industry and to trace its source is a most difficult task. However, the case at hand provides the analyst with two key advantages. First, coops and IOUs are engaged in essentially the same business. Second, comprehensive financial data are available for both sectors. Given inherently comparable companies and complete data, the relative value of the benefits received by coops and IOUs can be measured while avoiding the need to trace the source of every benefit.

In approaching the measurement of the subsidies received by IOUs and coops, it is crucial to understand that in a subsidy-free world, IOUs and coops could be expected to face similar capital and income tax costs. The reasoning behind this is as follows. The cost of capital to any firm is a function of the risk of the enterprise. The inherent risks associated with different firms in the electric utility business can be expected to be very similar. Indeed, if anything, because coops tend to be smaller and more concentrated geographically, the business risk inherently associated with those enterprises is greater. Therefore, were it not for government policies that directly affect utility capital costs, coops would face capital costs and associated federal taxes equal to or higher than IOU costs. For coops, this would be reflected in higher debt costs, the need to include substantial equity capital in their financial structure and the payment of federal taxes on income required to compensate stockholders.

From the proposition that IOUs and coops would face similar capital and tax costs in a subsidy-free world, it follows that the net effect of the subsidies provided to the two sectors can be measured by the difference between IOU pre-tax capital costs and coop pre-tax capital costs. If it is desired to develop some measure of the absolute level of subsidy provided to IOUs and coops, it is necessary to compare their actual pre-tax capital costs with the pre-tax capital costs that a private firm could be expected to incur if it were given no tax breaks (that is, if it paid federal income taxes at the full nominal tax rate).

Net Subsidy Received by Coops in 1982

The NRECA publications referred to in the text of my statement make no effort tc measure the total effect of the relative subsidies received by coops and IOUs in a particular year. The methodology used here to make that calculation for 1982 (the latest year for which complete data are available) is set forth below.

In the year 1982, as displayed in Table 1, IOUs incurred an average pre-tax capital cost conservatively estimated at 13.01 percent.

TABLE 1
1982 IOU PRE-TAX CAPITAL COSTS

9.64% x $119.1 billion long-term debt +

9.03% x $27.7 billion preferred equity +

13.63% x $92.8 billion common equity +

0.00% x $17.1 billion accumulated deferred taxes* +

$2.9 billion federal income tax paid +

$3.9 billion deferred tax charges* =

$33.4 billion divided by $256.7 billion total capital =

13.01%

*Deferred tax figures combine federal and state amounts.

Source: Edison Electric Institute, Statistical Yearbook of the Electric Utility Industry/1982.

This calculation is conservative in that it treats the cost of common equity capital as 13.63 percent, which was the rate actually earned by IOUs in 1982. However, the true cost of common equity was higher than this. This is reflected in the fact that the average return on common equity allowed by regulatory commissions was 15.90 percent in 1982. The treatment of deferred taxes deserves special note. In 1982, IOU customers received a substantial benefit in the form of lower rates as a result of the fact that $17.1 billion of capital was provided at no direct cost to IOUs by accumulated deferred income taxes. However, this benefit is the direct result of the fact that customers pay rates in any given year which cover income taxes due currently and, in addition, provide for income taxes deferred to future years. In 1982, such deferred income tax charges amounted to $3.9 billion. It would be inconsistent to recognize the benefits provided to IOU customers by accumulated deferred income taxes without also recognizing the deferred tax charges necessary to create those benefits.

The 1982 coop cost of capital, calculated in a comparable manner, was 9.80 percent, as shown in Table 2.

TABLE 2
1982 COOP PRE-TAX CAPITAL COSTS

8.60% x $30.4 billion long-term debt +

0.00% x $5.2 billion patronage capital +

$0.0 federal income tax paid +

$0.9 billion net margins =

$3.5 billion divided by $35.7 billion total capital =

9.80%

Source: 1982 Statistical Report, Rural Electric Borrowers, REA Bulletin Number 1-1.

This calculation recognizes that patronage capital is capital provided by customers which has no direct cost and thus is comparable to accumulated deferred income tax balances held by IOUs. It also recognizes that this benefit is created only because coop customers pay rates above current costs which result in net margins that accumulate as patronage capital. In 1982, such net margins were unusually high, amounting to $0.9 billion or more than 16.00 percent of patronage capital. Typically, net margins have equalled 9.00 to 10.00 percent of patronage capital. Nevertheless, to be extremely conservative, our calculations treat as a cost to coop customers the full $0.9 billion net margins earned in 1982.

The net capital cost and federal income tax subsidy provided to coops in 1982 thus resulted in their having pre-tax capital costs 24.70 percent lower than IOUs (9.80 percent versus 13.01 percent). This translated into a net subsidy advantage of $1.15 billion, or $120 per coop customer. Our findings are similar to Kiefer's. (Donald W. Kiefer, "Investor-owned Electric Utilities Versus Rural Electric Cooperatives: A Comparison of Tax and Financial Subsidies," Congressional Research Service, November 29, 1982.) Based on 1980 data, he concluded that coops had pre-tax capital costs 33.40 percent to 36.10 percent lower than IOUs. (Kiefer, at page 24. Compare coop cost of 10.25 percent with IOU cost of 15.38 to 16.04 percent.) The difference between Kiefer's results and ours is explained almost entirely by the unusually high net margins used in the 1982 coop capital cost calculations.

The figures set forth above do not include any measure of the additional subsidies conveyed to coops as a result of their preferential access to low-cost power produced at federal power projects. In 1982, preference power received by coops from federal power projects amounted to over 4,000 kilowatt-hours per customer. (43rd Annual Report of Energy Purchased by REA Borrowers, p. 6.) The average cost of this power was 1.1 cents per kilowatt-hour below the average cost of power purchased by coops from IOUs. Assuming that the subsidy associated with preference power amounted to 1.0 cents per kilowatt-hour, the estimated net subsidy enjoyed by coops would increase by $40 per customer.

To summarize, this analysis reveals that in the year 1982, as a result of federal tax policy toward IOUs and coops, the provision of insured and guaranteed loans to coops, and the granting of coop preference to low-cost federal power, coops received a net subsidy advantage over IOUs amounting to $160 per customer.

It should be noted that if it were desired to determine the direct cash cost to the federal government associated with the net subsidy provided to coops in 1982, several steps would be required. First, forgone federal income taxes would need to be calculated. In 1982, IOUs actually paid $2.9 billion in federal income taxes. This was equivalent to $11.30 per $1000 of IOU total capital. Had taxes been collected from coops at this same rate, they would have paid over $400 million in federal taxes that year. Second, and equally significant, it would be necessary to calculate the cash losses in 1982 resulting from the provision of a total of $10 billion in insured loans to coops at costs far below the federal government's borrowing rate. To do this accurately would require identifying the year that each outstanding loan was made to the coops, determining the long-term interest rate incurred by the government to borrow money that year and contrasting this with the interest rate charged to the coops. A rough estimate, however, is that the federal cost of funds provided to coops in 1982 exceeded the interest rate received by 3.50 percentage points. Given this, the direct out-of-pocket loss associated with those loans was $357 million in 1982. Forgone taxes plus lost interest thus amounted to an estimated $757 million, or $79.17 per coop customer in 1982.

The Subsidy Provided by Current Federal Policies

A different but relevant measure to examine is the level of additional subsidies being provided to IOUs and coops as a result of current federal tax and coop loan policies. This is what NRECA apparently aims to analyze.

The most recent NRECA analysis focuses on measuring the subsidy provided per customer. NRECA's analysis of the federal subsidies provided to coops is quite simple: it looks only at the net cash cost to the federal government of providing new insured loans to distribution coops in the year under consideration. For the year ending September 30, 1981, $850 million of insured loan commitments were made to coops. Utilizing an insured interest rate of 5.00 percent and a federal government long-term borrowing rate of 13.00 percent, the coop insured loans carried a net subsidy of 8.00 percent. Multiplying this by the total loan commitment produces a subsidy measure of $68 million, according to the NRECA analysis. To this, NRECA adds as a federal benefit provided to coops the cost to the government of operating the Rural Electrification Administration, or $15 million. The total subsidy to coops as measured by NRECA thus amounts to $83 million, or $8.91 per coop customer.

NRECA's IOU subsidy calculation is similarly straightforward. IOUs are seen as receiving subsidies because of two types of tax forgiveness by the federal government. First, they receive investment tax credits which serve as direct offsets to federal income tax liability. For the year 1981, the amount of such credits was $1.4 billion. Second, the use of accelerated depreciation for tax reporting results in IOUs receiving an interest-free loan from the U.S. Treasury. In 1981, the net deferred tax benefit was $2.2 billion. Summing the investment tax credit and accelerated depreciation benefit yields a total "subsidy" according to the NRECA analysis of $3.6 billion, or $50.70 per IOU-served electric customer. On a per-customer basis, that figure is over five times the coop figure.

As will be detailed below, the NRECA analysis contains three fundamental errors, each of which dramatically changes the calculated relative coop and IOU subsidies. (1) In the coop subsidy calculation, only the direct cash loss to the federal government associated with the provision of insured loans is viewed as a subsidy. Thus, the rate of interest charged on loans made to coops is compared with the federal government's borrowing rate, rather than being compared with the market cost of capital which would prevail absent government provision of insured and guaranteed coop loans. (2) No subsidy is attributed to the fact that coops pay no federal income taxes, yet any reduction in the tax liability of IOUs is viewed as an IOU subsidy. (3) The coop and IOU subsidies are not determined in a comparable way. Achieving comparability requires examining the federally-provided benefits that will flow to IOU and coop customers over the life of new capital outlays made in the year under consideration.

The first error in the NRECA analysis is that its calculation of the coop subsidy focuses only on direct cash losses to the federal government from the provision of insured loans. Thus, a 5.00 percent insured loan rate is compared to a 13.00 percent government cost of long-term funds to measure the subsidy. No subsidy is attributed to guaranteed loans provided to coops by the Federal Financing Bank because such loans carry interest rates equal to the government borrowing cost plus one-eighth of a percent, thus no direct cash outlay is involved. As discussed above, the proper measure of the relative subsidy provided to coops can be determined only by comparing their capital costs to the costs incurred by IOUs.

Let us consider first how this would affect the NRECA 1981 calculations. In 1981, IOUs raised $14.09 billion in outside capital. Of this amount, $8.27 billion was debt capital, with an estimated average interest rate of 16.36 percent. $1.93 billion of preferred equity was issued having an average cost of 14.50 percent. The remaining $3.90 billion capital was raised through the issuance of common equity. The most conservative measure of the cost of that common equity capital is the average return on equity allowed by regulatory commissions, or 15.20 percent. Given this, the composite after-tax cost of new outside capital to IOUs was 15.78 percent in 1981. This provides the proper after-tax basis for comparison with coop money costs because, as previously discussed, absent any federal government insurance or guarantees, there is no basis for expecting that coops could be financed on terms any more favorable than IOUs.

Properly comparing coop capital costs with IOU after-tax capital costs, rather than with the government borrowing rate, significantly changes the subsidy calculation. In the calendar year 1981, $940 million of insured loan funds were advanced to coops. These loans carried an average interest rate of 4.45 percent, rather than the 5.00 percent utilized in the NRECA analysis. Much more importantly, however, the NRECA calculation does not address the subsidy inherent in the guaranteed loans provided by the Federal Financing Bank. Guaranteed loans extended in 1981 amounted to $4.36 billion at an average interest rate of 14.24 percent. The composite cost of REA insured and guaranteed loans thus was 12.50 percent. Coops also obtained $291 million in other financing, primarily from the National Rural Utilities Cooperative Finance Corporation (CFC), at an approximate interest rate of 9.90 percent. The overall coop capital cost thus averaged 12.37 percent in 1981 or 3.41 percentage points less than IOU after-tax financing cost, as a result of federal government assistance. This differential multiplied by the total $5.59 billion in financing yields an estimated net subsidy figure of $191 million, or $20.49 per coop electric customer served in 1981. This is over twice the level shown by the NRECA analysis.

Data now are available to make comparable calculations for 1983. Data provided by the Edison Electric Institute (EEI) show that in 1983, IOUs raised $16.60 billion in outside capital. Of this amount, $7.95 billion was debt capital, with an estimated average interest rate of 12.39 percent. $1.96 billion of preferred equity was issued having an average cost of 14.32 percent. The remaining $6.73 billion of capital was raised through the issuance of common equity. (EEI, "Financial Info," April 16, 1984.) Again, the cost of that common equity capital is taken as the average return on equity allowed by regulatory commissions in 1983, or 15.40 percent. (EEI, "Financial Info," April 6, 1984.) Given this, the composite after-tax cost of new outside capital to IOUs was 13.83 percent in 1983.

Coop composite capital costs for the year ending September 1983 averaged 9.41 percent. This consisted of $674 million of insured loans advanced at an average interest rate of 4.59 percent; $3.12 billion of guaranteed loans extended by the Federal Financing Bank at an average interest rate of 10.38 percent; and $100 million of CFC loans at an estimated 11.50 percent interest rate. The 9.41 percent coop capital cost thus was 4.42 percentage points less than the IOU after-tax financing cost in 1983. This differential multiplied by the total $3.90 billion coop financing yields an estimated net subsidy of $172 million in 1983 or $17.99 per coop customer served.

The second major error in the NRECA analysis grows out of its inconsistent treatment of reductions in federal tax liabilities. No subsidy is attributed to the fact that coops pay no federal income taxes, yet any reduction in the tax liability of IOUs is viewed as a subsidy. To produce comparable calculations, both coop and IOU capital and tax costs must be compared with the pre-tax capital costs that an IOU would incur in a world of no tax breaks. The effect of this on NRECA's 1981 calculations is determined as follows. Had coops been subject to the same federal corporate income taxes as IOUs and had there been no benefits such as investment tax credits or accelerated depreciation to offset tax liabilities in 1981, it would have been necessary to earn a pre-tax yield on preferred equity of 25.24 percent in order to derive a 14.50 percent after-tax yield and a return of 26.46 percent on common equity in order to derive a 15.20 percent after-tax yield. [Given an average state income tax rate of 7.50 percent, the effective federal tax rate is 42.55 percent (46.00 percent times 92.50 percent).] The composite pre-tax cost of capital thus would be 20.37 percent. In a world of no tax breaks, no loan guarantees and no insured loans, this is the pre-tax cost of new capital coops could have been expected to bear in 1981. Stated differently, when the IOU subsidy calculation is performed, any reduction in tax liability below that yielded by statutory tax rates is treated as a subsidy. Therefore, to produce comparable figures, coop costs also must be compared with "no tax break" costs. Contrasting the 20.37 percent pre-tax capital cost with the 12.37 percent cost actually incurred by coops reveals that the coop advantage was 8.00 percentage points in 1981. At this rate, the total subsidy conferred was $448 million (8.00 percent times $5.60 billion in financing) or $48.06 per coop electric customer served.

Turning to 1983, were coops subject to the same federal corporate income taxes as IOUs and were there no benefits such as investment tax credits or accelerated depreciation to offset tax liabilities, it would be necessary to earn a pre-tax yield on preferred equity of 24.93 percent in order to derive a 14.32 percent after-tax yield and a return of 26.81 percent on common equity in order to derive a 15.4 percent after-tax yield. (The effective federal tax rate remains 42.55 percent.) The composite pre-tax cost of capital thus would be 19.70 percent. In a world of no subsidies, this is the cost of new capital coops could have been expected to bear in 1983. As noted above, the IOU subsidy calculation treats any reduction in tax liability below that yielded by statutory tax rates as a subsidy. Therefore, to produce comparable figures, coop costs also must be compared with "no tax break" costs. Contrasting the 19.70 percent pre-tax capital cost with the 9.41 percent cost actually incurred by coops reveals that the coop advantage was 10.31 percentage points in 1983. At this rate, the total subsidy conferred was $402 million (10.31 percent times $3.90 billion in financing) or $42.04 per coop electric customer served.

The third major error characterizing the NRECA analysis is its failure to calculate coop and IOU subsidies on even a conceptually similar basis. It is of crucial importance to understand the precise meaning of the coop figures produced by the NRECA-type analysis. The $48.06 per coop customer figure is the first year only value of the subsidy associated with new loans extended in 1981. It does not measure the present value of the benefits associated with those loans over their term. Nor does it measure the total benefits that coop customers received in 1981 as a result of all federal loans made in the past. In sum, it is a snapshot showing only one year's benefit associated with one year's loans. However, the NRECA approach to measuring the IOU subsidy does not produce a result at all comparable. Consider first the deferred tax benefit associated with accelerated depreciation. The $2.2 billion deferred tax amount treated as a subsidy in the NRECA analysis bears little relationship to new IOU investment activity in 1981. Instead, that represents the net 1981 tax saving resulting from the application of accelerated depreciation to all past and present IOU assets. The first year deferred tax benefit associated with new investments made in 1981—that is, the figure comparable to the coop subsidy calculation—is very much smaller. We can estimate that benefit as follows. In the year 1981, IOUs invested approximately $27 billion in new plant. If we assume that this plant was placed in service in mid-1981 and had an average life of 35 years, use of straightline depreciation would yield a deductible expense of $386 million (2.86 percent x $27 billion x one-half year). Use of Accelerated Cost Recovery System

(ACRS) accelerated depreciation (for a mixture of 44.00 percent 10 year property and 56.00 percent 15 year property) permits the IOU to deduct 6.30 percent of that investment, or $1,706 million, as depreciation expense in the first year. The additional tax deduction amounts to $1,320 million, which at a 42.55 percent effective federal tax rate, results in a first year tax saving of $562 million. Adding to this an investment tax credit of $2.70 billion produces a first year subsidy associated with new investment of $3.26 billion or $45.28 per IOU-served electric customer. This figure is only slightly less than the coop number.

However, the $48.06 versus $45.28 comparison greatly understates the relative coop advantage by focusing on first year benefits only. Why? Because the coop 8.00 percentage point capital cost advantage will persist at essentially the same level during each year of the life of the loans extended in 1981. Given an average loan term of 35 years, coop customers can expect to benefit by an amount equal to 7.88 percent of the 1981 loan during each year of the life of the loan. (This is calculated by comparing the levelized annual IOU pre-tax capital cost of 20.46 percent with the levelized annual coop capital cost of 12.58 percent.) This amounts to $47.21 per coop customer during each year. In sharp contrast, the $45.28 IOU figure represents a first year benefit only. Consider year two. In that year, the excess of ACRS accelerated depreciation over straightline depreciation for a full year will rise to $2,404 million, thus yielding a tax saving of $1,023 million (42.55 percent). A secondary tax saving of $65 million will result from the treatment of deferred taxes accumulated in year one as zero-cost capital. However, there will be no investment tax credit. Thus, the total second year saving associated with 1981 investments will be $1,088 million, or $15.10 per customer. The benefits will decline every year thereafter. Indeed, after the 15th year, annual federal tax payments associated with 1981 investments will be higher than if no ACRS accelerated depreciation had been taken.

Clearly, it is inappropriate to compare an essentially level annual coop benefit with the first year of a declining stream of IOU benefits. The proper figure to compare to the coop $47.21 number is the levelized annual value of the tax benefit provided to IOUs. At a 15.78 percent discount rate, this comes to $1,072 million, or $14.88 per IOU-served electric customer. In other words, the tax benefits resulting from use of ACRS accelerated depreciation and investment tax credits are sufficient to reduce the costs borne by the IOU and its customers by $14.88 per customer during each of the assumed 35 years of investment life.

The benefits conferred on coops and IOUs also can be expressed in terms of the relative cost of capital. As previously noted, in a world of no tax breaks, IOUs would face levelized capital costs of 20.46 percent per year in connection with 1981 investments. However, the levelized annual value of the investment tax credit and deferred tax benefits provided to IOUs was $1,072 million, or 3.97 percent of the $27 billion investment. The net levelized IOU capital and tax cost thus was 16.49 percent (20.46 percent - 3.97 percent). This is the proper number to compare with the coops' 12.58 percent figure for 1981.

The relative capital cost results may be compared with Kiefer's finding. Our analysis shows coop capital costs to be 23.70 percent lower than IOU capital and tax costs. (Compare 12.58 percent with 16.49 percent.) Kiefer's most nearly comparable results show coop capital costs 16.8 to 26.5

percent below IOU tax and capital costs. (Kiefer, p. 35. Compare the coop value of $85.97 with IOU values of $103.27 to $116.90 at a 15.00 percent discount rate.)

Stating the 1983 comparisons on a levelized basis produces a similar result. Coop customers can expect to benefit by an amount equal to 10.02 percent of the 1983 loans extended during each year of the life of those loans. (This is calculated by comparing the 1983 levelized annual IOU pre-tax capital cost of 19.85 percent with the levelized coop cost of 9.83 percent.) This amounts to $40.89 per coop customer during each year. In contrast, the levelized annual value of the tax benefits provided to IOUs via investment tax credits and ACRS accelerated depreciation taken on the $26.5 billion 1983 investment is $1,009 million, or $13.72 per IOU-served customer. The $1,009 million levelized benefit is equal to 3.81 percent of the IOU 1983 investment. The net levelized IOU capital and tax cost for 1983 thus was 16.04 percent (19.85 percent - 3.81 percent). This can be compared with the coop levelized 1983 cost of 9.83 percent.

Table 3 summarizes the relative subsidy findings just discussed.

TABLE 3
RELATIVE IOU AND COOP
SUBSIDY FINDINGS

	1981 NRECA Study	NRECA After Correcting to Use Market Capital Cost	NRECA After Correcting for Federal Tax Forgiveness	NRECA After Correcting to Levelize Calculations	1983 Corrected Results
IOU Subsidy Per Customer	$50.70	$50.70	$ 50.70	$14.88	$ 13.72
Coop Subsidy Per Customer	8.91	20.49	48.06	47.21	40.89

STATEMENT OF JILL LANCELOT, DIRECTOR OF CONGRESSIONAL AFFAIRS, NATIONAL TAXPAYERS UNION AND FRED L. SMITH, PRESIDENT, COMPETITIVE ENTERPRISE INSTITUTE

Madam Chairwoman and members of the Subcommittee, I represent the National Taxpayers Union, the largest nonprofit, nonpartisan public interest taxpayer's organization with a membership of 130,000 citizens. We are dedicated to lowering taxes and reducing wasteful government spending. Fred L. Smith, who heads the newly formed free-market, public interest advocacy group, the Competitive Enterprise Institute (CEI) has assisted in the preparation of this statement. We are pleased to be here today to offer our views on the impacts of S. 1300 on balancing the Rural Electrification and Telephone Revolving Fund (the "Fund") and to reexamine the role of the Rural Electrification Agency (REA) in U.S. rural policy. We commend you, Madam Chairwoman, for taking the courageous step in allowing this issue to be opened for debate.

You have heard and will hear from a large number of technical witnesses who are well-prepared to discuss the fiscal and policy implications of the REA financial problem. I am not an expert on public finance and recognize fully the complexities of the on-budget/off-budget, taxable/non-taxable, insured/non-insured aspects of this issue. However, one does not need to be an expert to realize that you cannot expect to remain in the black if you borrow high and lend low. At a time when most of the American public faces high interest rates due to enormous budget deficits, the REA loan recipients are in an enviable position. While the REA has borrowed funds at the rates available to all federal insured entities, it has been lending out their funds at extremely low rates. With such policies, it is not surprising that there is a shortfall of funds.

We oppose S. 1300 as a poorly thought-out attempt to resolve the financial difficulties that REA lending practices have created. The bill proposes to "solve" the Fund's problems by having the U.S. Treasury forgive the repayment of $7.9 billion of taxpayer money used for loans that it made to the Fund in 1973. Harold Hunter, the REA's Administrator, pointed out in his testimony before the House Agricultural Subcommittee that even with the forgiveness of the $7.9 billion, the Fund will still be insolvent. This solution is unlikely to solve anything -- it merely perpetuates the ability of the REA to continue its unsound lending practices.

The policy implicit in S. 1300 would create a very dangerous precedent for other off-budget credit programs to defer, reduce or cancel their debts to the U.S. Treasury. The permanent forgiveness of this $7.9 billion debt is questionable considering that the Fund is capable of repaying this obligation. Further, this does not show up in the official budget figures and, we believe, it represents a form of "backdoor" financing schemes that lessen the Congress's ability to control the federal budget.

Congress is being asked to pass S. 1300 as a means to assure the self-sufficiency of the Fund and yet it does not accomplish this aim. Although the bill would raise interest rates, the rates would remain well below projected borrowing costs. The Fund's receipts would increase but the Fund's interest expenses would overtake its interest income before the year 2010 according to the Congressional Budget Office. As these losses continue to erode the Fund's assets, Congress would be asked, once again, to remedy the shortfall.

In addition to opposing S. 1300 on the grounds of its unworthy fiscal and precedent setting implications, we wish to suggest that Congress reexamine the entire role of the REA. The original purpose of the 1936 Act was to distribute electricity and telephone service to farmers and rural areas. The REA has done a commendable job: today, 99 percent of rural America is electrified and 95 percent receive telephone service. Clearly, the goals of the original legislation have been met and the co-ops no longer need interest subsidies.

Moreover, a lot has changed since the 1930's. Much of rural America has become suburban and in some cases even urban. Often, co-ops provide much of the taxpayer subsidized power to suburban, commercial and industrial users...not to the small farms and rural households that the REA was created to serve. Further, because the subsidy is granted without regard to beneficiaries' income, it often goes to high income families, as well.

The role of the REA has moved away from its original intent in yet another way. The co-ops are no longer simply a distributor of power but have become power producers. A subsidy provided to a power producer serves only to distort the choices in the market place. The artificially low interest rates that REA co-ops pay induce them to generate power themselves and to over-invest in capital-intensive methods of producing power. Consumers also benefit from the artificially lower prices which causes them to use electricity wastefully. A study done by the National Economic Research Associates concluded that underpricing of electricity by co-ops leads members of co-ops to overuse electricity by about 4 percent.

We feel it is time that Congress reexamine and clarify the role of the REA program and to scrutinize the criteria used to determine the subsidies and its beneficiaries.

S. 1300 would short-circuit the opportunity to rethink the appropriate role for the REA now that it has achieved its original mission. The correct solution of bringing REA loan rates in line with market rates would have a small and, in most cases, a negligible effect on the costs of electricity to the average REA consumer. Interest rates are but a small part of the costs of generating and distributing electricity. Estimates by the Congressional Research Service suggest that it would cost an average of about $1.80 per year per percentage point adjustment. At worst, this suggests that customers would pay less than $20.00 extra per year. Of course, averages are dangerous and there may well be selected cases and regions where the impact would be greater; however, the REA Administrator already has the necessary authority to grant special relief in these cases.

This bill represents a classic case study of how special interest groups are able to manipulate the public and the Congress. It is not surprising that the House passed this piece of legislation by an overwhelming majority, considering that rural electric co-ops operate in 46 states and this is an election year. However, instead of blindly accepting the emotional rhetoric of the trade associations, the Senate has the opportunity to become informed and educated about this issue and reverse the decision of the House.

The Senate should defeat this legislation. In summary, the reasons are the following:

* The bill will not solve the Fund's financial problems. It only delays the day of reckoning at great expense to the taxpayer. The Administration estimates that if all sections of the bill are implemented it could cost the U.S. Treasury as much as $20 billion.

* The budget implications are serious. The bill would increase the borrowing/taxing requirements of the U.S. Treasury and raise interest rates for all Americans.

* The bill will create an extremely damaging precedent for the many other off-budget loan programs that will also expect to request "forgiveness."

* The bill will continue a major non-means tested subsidy to some special interests.

That concludes our testimony, Madam Chairwoman. Thank you for allowing us to present our views.

STATEMENT OF JACK DOYLE, DIRECTOR, RURAL LAND AND ENERGY PROJECT ENVIRONMENTAL POLICY INSTITUTE

Madam Chairman, Members of the Subcommittee:

For the record, my name is Jack Doyle. I am Director of the Rural Land and Energy Project of the Environmental Policy Institute, a Washington-based public interest research and educational organization focusing on energy and natural resource policy at the federal level. We are appearing here today at the invitation of the subcommittee to discuss some of the findings in our study of rural electric cooperatives, Lines Across the Land. We are pleased to be here today, and hope that our testimony and supporting material will be helpful to the subcommittee in its inquiry of REA and co-op procedures.

Two years ago we released our study -- Lines Across the Land -- one of the largest and most costly studies ever undertaken by the Environmental Policy Institute. Lines Across the Land investigated the REA and co-op systems on a wide range of topics, including their history, their environmental record, their relationship with farm groups, their relationship with investor-owned utilities, their political power base, their changing structure, and their energy policies. More than half of the book is comprised of 14 case studies, some of which were written by co-op members.

We believe that Lines Across the Land has performed a public service for many rural people and cooperative members all across the country. We further believe that our study was a fair and accurate analysis of how REA and rural electric cooperatives operate throughout rural America and in Washington, D.C. We stand by its findings. Contrary to some of the study's detractors, whose initial knee-jerk responses even before reading the study, charged that we were out to "get REA" or "ruin the REA system" -- our intention, stated many times in public and in the press, was to move the REA system closer to its members, back to its original progressive tenets, and to suggest that energy conservation, solar and other renewable energy options could provide the substance of reform and revival throughout the entire REA system nationwide. And it is from that premise, and with these intentions of reform and re-direction, that we appear here today to offer our views.

Among some of the most disturbing findings in Lines Across the Land were those having to do with how rural electric cooperatives relate to their consumers. Rural electric cooperatives, unlike investor-owned utilities, are owned and operated by the consumers, who are often referred to as "member-owners". Co-ops are supposedly run on democratic principles of equal representation, open access to meetings and information, and the opportunity for any member to run for a board seat. Co-op members, in other words, are supposed to run and control their own cooperatives. Unfortunately, this is not what we found in Lines Across the Land.

Although rural electric managers and directors, and even REA officials, have stated that co-op members can work within the co-op system to change policy and propose their own initiatives, we found evidence to indicate that such opportunity to effect policy change, or to challenge specific co-op decisions, was subtly qualified, restricted or simply quashed by dictatorial local managers, co-op lawyers, and/or G&T officials.

Some of the findings in Lines Across the Land concerning member access to information, co-op elections and redress and appeal procedures include the following:

- in some states, the governing bylaws of co-ops are sometimes denied to co-op members, or are not routinely distributed to new co-op members unless requested in writing.
- some co-op bylaws vest local boards with the power to set rates, policy and operation charges without membership notification or approval.
- in some states, co-ops have not abided by the terms of their original state charters.
- in Alabama, Minnesota, Illinois, Virginia and other states, co-op members have been denied such information as mailing lists of co-op members; copies of agreements which form G&T systems to which co-op members belong; contracts and agreements pertaining to power projects from which members will recieve power and upon which future rates will be based; minutes of general co-op and board meetings; and the right to inspect co-op books and records.
- some co-ops have refused to disclose fees paid to directors.
- at annual meetings in some co-ops, members have to be on a formal agenda in order to speak.

- in Texas and Minnesota, local co-op members in some systems have been denied the opportunity to speak from the floor at annual meetings.
- in Texas and Virginia, proxy votes have been used to swing local co-op board elections to favored candidates.
- in Minnesota, mail ballots have been used in the election of board members.
- in some co-ops, local board members have not resided in the co-op service area while serving on the board.
- petition, redress, and recall procedures in some co-ops are often subject to review and judgement by local co-op directors, even when such petitions or recall motions are directed at the board members themselves.
- in Ohio and Alabama, member-initiated peition drives for redress or recall purposes have been stymied or disqualified on the basis of "improperly drawn petitions", "duplicate signatures", or on grounds that individual petitioners "had not signed their membership cards".
- in one local co-op board election in Illinois, an incumbent board of directors sent a letter to co-op members smearing a local co-op member who was a candidate for a board seat.

Sadly, these practices have not abated since the publication of Lines Across the Land. In June 1980, for example, the Dunn County Electric Cooperative in Wisconsin witnessed a struggle over a challenge to a by-law provision that was only adopted the previous year. That provision limited board seats to 3 successive 3-year terms, or 9 years. Board members favored amending that provision in order that they would all be grandfathered in, so that the 3-term limitation would only begin ticking as of January 1, 1981. In other words, their position was that existing board members, regardless or how long they had been in office, should be given another 9 years. Co-op reformers felt that the provision should stand as originally incorporated, meaning that anyone presently on the board who had served three successive terms or more would not be eligible to run again. Shortly before the annual meeting, the manager of the co-op sent a letter to the membership explaining that the original limitation was backed by a small group of people trying to take over the co-op. After three separate counts of the vote at the annual meeting, it was determined that the supporters of the original limitation had narrowly won. That last count was supposedly the official, final vote. However, a few days later, the manager called a special board meeting and called in three special ballot counters, whereupon the board determined that the official vote had actually been in favor of the board-supported position. Supporters of the original limitation are today in court suing the co-op over the incident noting that the board had conducted an illegal recount, had a vested interest in the outcome of the vote, and had violated co-op bylaws by not making proper notification of the meeting.

Incumbent local boards have become a problem for many co-op members all across the country, with some board members serving as many as 20 and 30 year terms. These board members often comprise the nominating committees or appoint such committees, who then determine candidate slates for co-op elections. It is not surprising therefore that incumbent boards are re-elected time and time again. This is why a limitation on term of service is such an important first step for co-op members trying to restore democratic control to their co-op.

On a similar measure to that tried in Wisconsin, also limiting the terms of board members to 3 successive 3-year terms, the Illini Electric Cooperative of Illinois faced a vote in February of this year. According to one co-op member who attended this meeting, there was a "concerted effort on the part of the board to get votes against the amendment."

This is not to say that there have not been any reforms. Some co-op reformers in Minnesota and Michigan have themselves been elected to local co-op board seats. In Minnesota, a "co-op bill of rights" was offered in the state legislature, and is still pending this term. A similar measure is being proposed for Wisconsin. Co-ops in Minnesota now have the right to bring themselves under state regulation through votes of their local co-op membership, and a few have elected to do so this year. But such reforms tend to be the exception rather than the rule.

In many respects, the problems of member access to information and fair treatment in election, redress, and recall procedures, flow from the changing structure of the REA system nationwide. Since the late 1960's, and even somewhat before then, political and financial power within the rural electric system has moved away from the 950 local co-ops and increasingly toward some 50 G&T co-ops. Electric service and supply decisions have become increasingly centralized and lodged at the G&T level. Consequently, co-op members at the local level are the last to know of G&T plans for future power supply, and it is these decisions that often have to be defended and protected by local boards, and such defense often manifests itself in various undemocratic ways.

Although G&T's are fond of pointing to the "representative" composition of their boards, and the contention that "any decision made by the (G&T) Board of Directors is subject to being overridden by the membership", very few if any major decisions — such as those to build a large powerplant or begin a joint venture with an investor-owned utility -- are ever put to a full vote by the co-op membership within the G&T system. In fact, very few such decisions — involving millions of dollars — are seriously debated by local co-op memberships due to the strictures imposed on member participation. For example, in Kansas a few months ago, a local co-op member trying to discuss with his local board some questions about the merits of buying into the Wolf Creek nuclear power project was denied permission to attend the meeting, but was allowed to submit a list of written questions.

The rural election establishment spends large sums of money "educating" its managers and boards of directors, gives generously to political candidates of both parties, and is not bashful about selling its point of view to the general public in major newspapers and magazines outside of rural areas. Although local members too are barraged by co-op literature, it is for the most part, the co-op point of view, or more precisly, management's point of view. Even on some "so-called" opinion pages in co-op publications, letters from co-op members have been turned away because they did not agree with the "party line".

In a nutshell, what we found in Lines Across the Land is that the co-op philosophy as applied to the rural electric system has been turned upside down: instead of being a democratic, grass roots, "bottom-up" system where policy is derived from member-to-manager, rural electric co-operative policy making begins at the very apex of the system, -- at the G&T level -- and is force fed downward to manager, director, local board members, and ultimately consumers through a wide assortment of techniques.

We believe that the REA system could revitalize itself, diversify its energy base, and save ratepayers and the federal government millions of dollars by pursuing a crash program in energy conservation and renewable energy options. Unfortunately, local co-op boards and G&T systems have "powerplant blinders" on and will not consider the vast, diverse potential that energy conservation and renewable energy options present to their systems. We also believe that such a concerted effort in new energy sources could spur reform movements among co-op members and within state legislatures.

Unfortunately, local co-op boards and G&Ts have become quite comfortable with the status quo, and many have lost their flare and enthusiasm for innovation and the consumer's best interest. Since the Arab oil embargo, rural electric cooperatives have failed miserably with REA's weak-wristed energy conservation and home weatherization programs.

Since the Arab oil embargo, REA loans and loan guarantees for electric distribution lines, high-voltage transmission lines and powerplants have totaled more than $30 billion. However, REA loans for energy conservation and home weatherization during that same period have totaled no more than $4 million, or about .014% of total REA financing during that period. A pretty poor showing for 7 years and a system that services 8 million REA families, or 25 million consumers.

Even assuming an energy conservation expenditure of $30 million by all REA co-ops, the "conservation share" then rises to a mere .1% of all REA financing since the Arab oil embargo. In any event, within the REA system, there is a very wide gap between "electric growth" expenditures and "energy conservation" expenditures, and this has resulted in very large demands on federal borrowing.

While REA and some local cooperatives have moved forward in good faith to try to improve the co-ops' energy conservation record, REA energy conservation programs have generally failed for three reasons: 1) they are not mandatory, 2) they are not tied to clear energy conservation goals, and 3) they are aimed at the wrong level -- some 950 local co-ops rather than the

50 to 60 "G&T co-ops".

An energy conservation amendment aimed at G&T co-ops, with clearly stipulated energy conservation goals, and required as a condition of continued access to the Federal Financing Bank for loan guarantees, would have the effect of co-ordinating local co-op conservation programs throughout the nation, while reducing the amount of off-budget financing needed for new REA powerplants. In May 1980 testimony before the Senate Subcommittee on Agricultural Credit and Rural Electrification, former REA Administrator Robert Feragen presented a table which showed that the difference in financing requirements for a 1% growth rate and a 9% growth rate in the REA system during the 1980-1989 period would be $76.2 billion (in constant dollars). Using Feragen's table, and assuming an installed capacity cost of $1,200 per KW, the difference between a 3% and a 6% growth rate is roughly 16,000 MW, or about $25 billion in financing costs for the 1980-1989 period. Such differences -- made possible through an energy conservation requirement aimed at the G&Ts -- could result in significant savings in federal credit outlays.

Such a requirement would help coordinate local co-op energy conservation programs within G&T systems, would promote jobs in home weatherization and other energy conservation businesses throughout rural America, and would help reduce the amount of off-budget federal borrowing needed by REA to finance new powerplant construction. A 1% annual reduction in electric demand by G&T systems would save millions of credit dollars in federal borrowing, "freeing up" such federal borrowing for housing, agriculture and small businesses.

In closing, we would respectfully suggest to this subcommittee that Lines Across the Land, and all the various newspaper accounts, GAO reports, and books on co-op powerlines, etc., may have only touched the tip of the iceberg. There are, no doubt, thousands of rural electric co-op people in rural America who have stories to tell about how their own local co-op could be doing a better job. We would encourage this subcommittee to go to the people; go out in the country and solicit that opinion.

There are problems of rate regulation, joint venture arrangements, and the lack of effort on energy conservation and renewable energy alternatives that all need to be explored in some detail. We would also encourage this subcommittee to explore the relationship between local co-ops and the G&T systems, and how local co-op boards and co-op members really feel about the arrangements they have with G&T systems, how they feel about joint ventures with investor-owned utilities and how they feel about REA.

We thank the subcommittee for the opportunity to appear here today to express our views.

(The following material was submitted by Jack Doyle:)

ENVIRONMENTAL POLICY CENTER
317 Pennsylvania Ave., S.E., Washington, D.C. 20003
202/547-5330

20 October 1981

To: Members, U.S. House of Representatives

Re: REA Energy Conservation Requirement Needed for Continued Federal Borrowing

Floor Action: 1981 Farm Bill (H.R. 3603)

Dear Congressman:

Rural electric cooperatives are found in at least 200 congressional districts in 46 states. Collectively, some 1,000 REA-supported co-ops comprise the nation's single largest electric distribution system. Their service territories cover 75% of the land area of the U.S.

Once a progressive, grass roots movement that transformed rural America by bringing cheap, reliable electric service to even the most isolated rural community, REA co-ops today have failed badly on the energy conservation front.

Since the Arab oil embargo, REA loans and loan guarantees for electric distribution lines, high-voltage transmission lines and powerplants have totaled more than $30 billion. However, REA loans for energy conservation and home weatherization during that same period have totaled no more than $4 million, or about .014% of total REA financing during that period. A pretty poor showing for 7 years and a system that services 8 million REA families, or 25 million consumers.

Even assuming an energy conservation expenditure of $30 million by all REA co-ops, the "conservation share" then rises to a mere .1% of all REA financing since the Arab oil embargo. In any event, within the REA system, there is a very wide gap between "electric growth" expenditures and "energy conservation" expenditures, and this has resulted in very large demands on federal borrowing.

While REA and some local cooperatives have moved forward in good faith to try to improve the co-ops' energy conservation record, REA energy conservation programs have generally failed for three reasons: 1) they are not mandatory, 2) they are not tied to clear energy conservation goals (such as specifically targeted 5 and 10 year plans), and 3) they are aimed at the wrong level--some 950 local co-ops rather than the 50 to 60 "G&T co-ops" (i.e., generating and transmission cooperatives who build powerplants and account for the lion's share of REA financing, $5-6 billion annually).

In order to improve REA's energy conservation record, Section 306 of the Rural Electrification Act of 1936 needs to be amended in Title XV of the farm bill, H.R. 3603. An energy conservation amendment aimed at G&T co-ops, with clearly stipulated energy conservation goals, and required as a condition of continued access to the Federal Financing Bank for loan guarantees, would have the effect of co-ordinating local co-op conservation programs throughout the nation, while reducing the amount of off-budget financing needed for new REA powerplants. In May 1980 testimony before the Senate Subcommittee on Agricultural Credit and Rural Electrification, former REA Administrator Robert Feragen presented a table which showed that the difference in financing requirements for a 1% growth rate and a 9% growth rate in the REA system during the 1980-1989 period would be $76.2 billion (in constant dollars). Using Feragen's table, and assuming an installed capacity cost of $1,200 per KW, the difference between a 3% and a 6% growth rate is roughly 16,000 MW, or about $25 billion in financing costs for the 1980-1989 period. Such differences--made possible through an energy conservation requirement aimed at the G&Ts--could result in significant savings in federal credit outlays.

The Environmental Policy Center believes that REA co-ops still need the assistance of the Federal government in the credit market, and that co-ops should still have access to government-backed loan guarantees through the Federal Financing Bank (FFB). However, such continued access and federal assistance must be strictly conditioned on the achievement of reductions in electric energy demand through energy conservation programs.

It is not out of the question, for example, that each G&T system be required to achieve a 1% annual reduction in electric demand throughout its system as a condition of REA loan guarantee eligibility. REA power supply borrowers ("G&Ts") could be required to reduce electric demand by 1% a year throughout their supply area and among their local distribution cooperatives during the amoritization period of any loan guarantee secured through the Federal Financing Bank of the U.S. Treasury.

Such a requirement would help coordinate local co-op energy conservation programs within G&T systems, would promote jobs in home weatherization and other energy conservation businesses throughout rural America, and would help reduce the amount of off-budget federal borrowing needed by REA to finance new powerplant construction. A 1% annual reduction in electric demand by G&T systems would save millions of credit dollars in federal borrowing, "freeing up" such federal borrowing for housing, agriculture and small businesses.

It is certainly in the nation's best interest, and in the interest of reducing the amount of federal borrowing currently taking place in the nation's credit market, that only the most efficient and most important federal borrowing be continued. Through properly directed energy conservation programs, REA cooperatives can reduce the amount of federal financing they will need during the next 10 years and beyond.

The Environmental Policy Center therefore urges you to support an REA energy conservation amendment in the 1981 farm bill that saves both energy and money.

Respectfully,

Jack Doyle

Jack Doyle
Washington Representative

REA ENERGY CONSERVATION INITIATIVES SINCE THE ARAB OIL EMBARGO

	RHETORIC	REALITY	
	Stated Government Policy and/or REA Programs	Actual Spending (REA Loans & Loan Guarantees, $ Millions)	
1974	"Project Independence" announced	Electric Distribution:	$ 618.6
	"REA borrowers are making every effort to adopt rates that will promote the conservation of energy..." REA, Report of the Administrator	Powerlines & Power Plants:	$ 974.4
		Energy Conservation:	$ 0
1975	Energy Policy and Conservation Act of 1975 enacted.	Electric Distribution:	$ 700.0
		Powerlines & Power Plants:	$ 1,206.3
		Energy Conservation:	$ 0
1976	"Because of changes that have occurred in energy availability and price, REA has been making special efforts to keep its borrowers informed of electric energy conservation measures..." REA, Report of the Administrator	Electric Distribution:	$ 750.0
		Powerlines & Power Plants:	$ 1,241.5
		Energy Conservation:	$ 0
1977	Carter Administration announces National Energy Plan.	Electric Distribution:	$ 850.0
	REA Energy Conservation Committee established.	Powerlines & Power Plants:	$ 3,985.5
		Energy Conservation:	$ 0.048
	USDA announces Joint FmHA-REA Home Weatherization Loan Program in February.	REA survey reveals less than 10% of co-ops have energy conservation policy.	
1978	"...aggressive, locally developed and consumer-oriented energy conservation programs will soon become a factor in determining the eligibility of a rural electric distribution co-operative for a loan or loan guarantee..." USDA News August 1978	Electric Distribution:	$ 900.0
		Powerlines & Power Plants:	$ 2,309.0
		Energy Conservation (REA-FmHA):	$ 0.448
		REA indicates 235 of 983 co-op systems "have agreements with FmHA to process home weatherization loans."	
1979	"Energy conservation programs required in all loan applications from distribution borrowers." (i.e., local co-ops) Rural Lines USA, REA	Electric Distribution:	$ 1,000.0
		Powerlines & Power Plants:	$ 5,429.7
		Energy Conservation (REA-FmHA):	$ 0.704

REA-FMHA Weatherization Program: A Failure

> "Some have criticised the REA for not taking the leadership role it ought to assume, and have said that the co-ops have not been getting the conservation job accomplished. In 1977, the Department of Agriculture announced with a great flourish a home weatherization program whose goal was to weatherize 4 million rural homes. To date, fewer than 3,000 have been weatherized. That effort seems more than somewhat puny."
>
> Senator Edward Zorinsky, "REA
> and Energy Conservation", Hearing
> Before the Senate Subcommittee on
> Agricultural Credit and Rural
> Electrification, May 6, 1980

> "I am sorry to have to admit to the failure of the REA-Farmers Home Administration weatherization program. I think we did not achieve what we had hoped to achieve and what the Department had hoped to achieve. It is not a good record to say that we have only gotten $1,300,000 of weatherization in rural homes.
>
> Robert Feragen, REA Administrator
> May 6, 1980

1980

"REA's loan policy effective January 1, 1980, is that borrowers must demonstrate a serious commitment to conservation as a condition of REA loan approval."

Electric Program
Chart Book, REA

REA announces new Section 12 loan deferral weatherization program.

Electric Distribution:	$ 925.0
Powerlines & Power Plants:	$ 5,660.1
Energy Conservation:	$ 0.050

(Section 12 conservation loans)

34 Section 12 weatherization loans were made by REA in 1980.

1981

"NRECA took the leadership in bringing our systems into the conservation age.... It has been tough going from a promotional era to a conservation era; but now, most rural electric cooperatives view conservation and load management programs as important options that help them meet their members' needs."

D.L. Knight, Rural
Electrification,
February 1981

Electric Distribution:	$ 850.0
Powerlines & Power Plants:	$ 4,994.9
Energy Conservation:	$ 0.903

173 of REA's 983 active co-op borrowers have agreed to participate in Section 12 weatherization program.

As of October 1, 1981, REA has still not established a mandatory energy conservation program with clearly specified goals for achieving reductions in electric energy demand, administered through G & T co-ops.

REA ENERGY CONSERVATION PROGRAMS

		# of Loans	Amount of Loan
REA-FmHA Weatherization	1977	59	$ 48,000
	1978	513	448,000
	1979	796	704,000
	Subtotal	1,368[1]	$1,200,000
Section 12-Energy Resource Conservation Loans	1980	34	50,000
	1981[2]	779	903,000
	Subtotal	813	$ 953,000
	TOTAL	2,181	$2,153,000

Source: U.S. Rural Electrification Administration

1. Only 240 of the 1,368 loans made in this weatherization program were made through REA co-ops.
2. As of August 1981. Although 779 loans have been made by REA co-ops in 1981, there are over 8 million households served by REA co-ops nationwide. Moreover, only 44 co-ops--less than 5% of all REA co-ops--have actually made one or more Section 12 Energy Resource Conservation loans in 1981.

STATES IN WHICH REA CO-OPS HAVE NOT MADE AT LEAST 1 SECTION 12 ENERGY RESOURCE CONSERVATION LOAN

1980-1981

Alabama
Alaska
Arkansas
California
Delaware
Idaho
Illinois
Indiana
Iowa
Kentucky
Maine
Maryland
Michigan
Mississippi
Montana
Nebraska
Nevada
New Hampshire
New Jersey
New York
Oklahoma
Oregon
Pennsylvania
Tennessee
Utah
Vermont
Virginia
West Virginia
Wyoming

Source: U.S. Rural Electrification Administration, as of August 1981.

POWER SUPPLY FINANCING NEEDED BY REA BORROWERS AT VARIOUS LEVELS OF ELECTRIC GROWTH

Annual Load Growth, 1980-89	Percent of Total REA Borrower Needs Supplied by Borrower's Own Generation 1/		MW of Additional Capacity Financed 2/			Billion Dollars of Financing Required					
						Constant (1980) $ 3/			Nominal $ 4/		
			Total	Annual Average		Total	Annual Average		Total	Annual Average	
	1980	1989	1980-89	1980-84	1985-89	1980-89	1980-84	1985-89	1980-89	1980-84	1985-89
1%	36.0	51.7	6,989	835	563	$10.5	$ 1.3	$ 0.8	$$14.6	$ 1.5	$ 1.5
2%	36.0	52.5	9,937	1,081	906	14.9	1.6	1.4	21.2	1.9	2.3
3%	36.0	53.7	13,796	1,393	1,366	20.7	2.1	2.0	29.9	2.5	3.5
4%	36.0	54.4	18,518	1,759	1,944	27.8	2.6	2.9	40.6	3.1	5.0
6%	36.0	55.8	30,572	2,638	3,477	45.9	4.0	5.2	68.2	4.6	9.0
8%	36.0	57.2	46,631	3,759	5,567	69.9	5.6	8.4	105.1	6.6	14.4
9%	36.0	57.8	57,830	4,446	7,120	86.7	6.7	10.7	131.2	7.8	18.4

Assumptions: 1/ REA's best judgement concerning source of future power supply for REA borrowers.

2/ 50% load factor; a four year lead time between loan approval and on line dates; reserves equal 20% of required capacity.

3/ 1980 cost per KW of $1,200 plus financing for bulk transmission facilities in an amount equal to 25% of generating plant investment.

4/ Constant (1980) $ inflated at an annual rate of 8%.

Note: MW = one thousand Kilowatts of capacity.

Source: Robert W. Feragen, Hearing Before the Subcommittee on Agricultural Credit and Rural Electrification, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, May 6, 1980.

REA AND ENERGY CONSERVATION:

THE NEED TO DO MORE

REA: "An Enormous Opportunity For Conservation":

"Rural electric co-ops are today the fastest growing segment in the electric utility industry and are expected to provide 20 percent of the Nation's electric supply by the year 2000. There are approximately 1,000 such co-ops serving 25 million people and occupying 75 percent of the land area of the United States. For this reason alone, they provide an enormous opportunity for conservation and small-scale renewable technologies.

The Rural Electrification Administration is a central force in the rural electric movement by helping the co-ops finance service to rural customers. Each year the REA provides billions of dollars in loans and loan guarantees to these utilities. With its vast resources, the agency could also support co-op projects in conservation and renewable energy technologies, which would be infeasible without REA financial and technical assistance."

Senator Paul Tsongas, Senate
Subcommittee on Energy Conservation
and Supply, July 11, 1979

REA Administrator, Harold Hunter, Supports Energy Conservation:

"Rural people should be made aware of how a successful load management program can defer the need for additional plant. The message is clear: each dollar invested in additional plant increases the average cost of serving consumers. That is why borrowers' progress in home weatherization, load management, and supplementary technologies are so important to REA borrowers and consumers they serve."

Harold V. Hunter
Washington, D.C.
September 21, 1981

GAO Cites G&T Role in Energy Conservation:

"REA, working primarily through its distribution system borrowers, has taken actions to help solve our Nation's energy problems. We believe, however, that the power supply systems could be better used as a focal point for this effort.

The power systems [i.e., G&T co-ops], with their overall responsibility for planning for and meeting the power requirements of the distribution systems they serve, are in good position to help plan to (1) reduce the demand for energy through conservation measures, (2) use available plant capacity as efficiently as possible through effective load-management efforts, and (3) use alternative renewable energy sources to the maximum extent practicable to reduce our Nation's dependence on foreign oil and to conserve our own natural resources...."

Comptroller General's Report to
the Congress, Financing Rural Electric Generating Facilities: A Large
and Growing Activity, November 28, 1980

20% Savings in Wisconsin Dairy Industry:

"...The Wisconsin Energy Office has predicted in testimony before the State's Public Service Commission that one device alone--heat exchangers for cooling milk and heating water--can be responsible for a 20 percent reduction in Wisconsin's agricultural electrical energy use by the year 2000."

Randy Freeman, Pierce-Pepin Electric
Co-op, Wisconsin, Hearing before the
House Subcommittee on Conservation &
Credit, March 1980

REA Energy Conservation: Long-Term Budget Savings:

> "In addressing the rural electric cooperative leadership at the NRECA annual meeting in New Orleans, ... it was stated that it is in the nature of energy conservation programs to have short-range impacts upon revenues. But it was emphasized that the long-term benefits of averting substantial capital outlays for new electric capacity would be a much greater gain for their future financial outlooks than the actual cost of conducting conservation programs or the short-term negative impact upon revenues.
>
> ...As I stated previously, conservation practices for rural cooperative members will have a negative impact on system revenue, but will produce long-term benefits because the need for additional high cost new capacity will have been obviated.
>
> It should be remembered that the continuing growth in the number of consumers on rural electric systems will mitigate the effects of reduced consumption by the present consumers...with a 1 percent annual load growth a total of about 7,000 MW of capacity, at a cost of $10.5 billion (1980 dollars) will be required. If, however, the annual load growth were 9 percent, almost 58,000 MW of capacity, at a cost of almost $87 billion (1980 dollars) will be required. In all likelihood, the actual load growth through this period will be in the middle of these two extremes. This indicates the importance of an effective conservation program to reduce load growth...."

Robert Feragen, Former REA Administrator, Hearing before the
Senate Subcommittee on Agricultural
Credit and Rural Electrification
May 6, 1980

Former Agriculture Secretary Bob Bergland: REA & Energy Conservation:

> "I have asked NRECA to work with REA to develop an aggressive and effective energy conservation program and to help borrowers with their own initiatives.... An aggressive energy conservation program--one which devotes a reasonable amount of resources and personnel--is the best opportunity to keep costs down and minimize the need for additional loan funds. Such a program should, in the consumer and national interest, be a requirement for continued REA financing."

Bob Bergland
REA New Managers Conference
Washington, D.C., April 1978

RURAL AMERICA

February 1980

High-Powered Controversy

For more than 40 years, the rural electrification movement has been a force for progress and social change in rural America. Beyond the electrification of millions of farms and rural homesteads (no simple achievement in the 1930s), the Rural Electrification Administration (REA) and its nearly 1,000 local electric co-ops have helped create an important network of consumer-controlled institutions in rural communities that is unique in the social history of our nation. The movement reflects a successful partnership between federal commitment and resources on the one hand, and local leadership and organization on the other—a partnership that has withstood four decades of determined opposition from private utilities and other vested interets.

Since its inception, Rural America has consistently identified itself with the progressive historic forces that helped create the rural electric movement, the Farm Security Administration and other efforts to improve the lives of rural people. Many times, we have joined with local electric co-ops and their national association, the National Rural Electric Cooperative Association, to assure rural equity in the development and implementation of federal policies.

In recent months, the rural electric program has come under criticism for its policies in the areas of energy development and conservation, and a spirit of reform aimed at the rural electric cooperatives is emerging in many rural areas. Increasingly, in publications like *Lines Across the Land* (which is reviewed on page 6), the local co-ops are being linked both to private coal companies and to private interests seeking to develop synthetic fuels. For some time, we have been concerned that, despite some pioneering conservation practices on the part of Basin Electric Cooperative and other individual co-ops, the organized rural electric voice at times has sided with the private power concerns against aggressive federal stripmining regulations and in favor of expanding nuclear power.

As concern and controversy over national energy policies increase, it is inevitable that there will be closer scrutiny of the practices of REA and other publicly controlled electric systems. This, we believe, is desirable, since such examination and debate can only lead to a strengthened and invigorated REA system. We reject the notion that we cannot criticize REA without supporting the adversaries of the rural electric program; similarly, we reject the view that the rural electric co-ops are indistinguishable from private, investor-owned utilities. It is impossible to adequately address rural energy issues without thoroughly examining the role played by REA and, where necessary, insisting that those practices working to the detriment of rural people be changed. After all, the rural electric system is *our* system, and we have more than just a minor stake in how it works.

[Reprint from Des Moines Sunday Register (IA), May 10, 1981]

RURAL ELECTRIC CO-OPS SIZZLE OVER PLANS TO CUT THEIR SUBSIDIES

(By George Anthan of the Register's Washington Bureau)

WASHINGTON, DC.—They begin arriving here tonight, the first contingent of an army of officials and board members of rural electric cooperative's from across the country. They're angry at President Reagan's attempt to cut the subsidies to which they've become accustomed in the 45 years since the New Deal replaced the countryside's familiar windmills with power lines.

By the end of this week, more than 2,000 officials and employees of the cooperatives from some 200 different congressional districts will have told their story to senators and congressmen. Their message: Cutting back the federal subsidies to the rural electrics won't save a dime in federal spending but will cause already burdened rural consumers to pay even more for their electricity.

Already, a wide range of congressmen and senators who represent rural areas, including some usually loyal Reagan supporters, have notified the White House that this is where they draw the line.

FARM-STATE UNITY

Many farm-state members of Congress are rallying behind the co-ops in their battle with the White House. Last month, eight senators, including Republicans Roger Jepsen and Charles Grassley of Iowa, sent a letter to Reagan opposing moves to cut co-ops off from federal financing. "We must not leave rural cooperatives out in the cold," Jepsen said.

The administration may have some unlikely allies in its fight to trim the cooperatives' subsidies since an environmental group released a controversial study of the rural electrics. The study charged the cooperatives had bypassed environmental laws, avoided energy conservation, abused rural landowners and effectively isolated their member-owners from the decision-making process.

In fact, the whole world of the rural electric cooperatives has been turned topsy-turvy. Among their chief allies, now, are their once bitter enemies—the nation's privately owned utility companies. This is because the cooperatives, in the last decade or so, have entered into a series of joint ventures with the private firms to build large nuclear and coal-fired generating plants. The private utilities have benefited because the cooperatives bring with them the low-cost credit the government makes available.

BUYING NUCLEAR PLANTS

For example, two Iowa co-ops—Central Iowa and Corn Belt—used some $66 million in subsidized federal funds to buy a 30 percent share in the Duane Arnold nuclear power plant constructed by Iowa Electric Light and Power Co.

The Reagan administration contends the rural electric co-ops have largely accomplished the task of providing power to rural and isolated parts of the country, and should depend more on commercial credit.

The administration wants to raise interest rates on the direct government loans from 2 percent to 5 percent.

Also, Reagan wants to end the practice of allowing the big generating and transmission cooperatives to get most of their money from the Treasury, at rates averaging about 1.5 percent below commercial credit. Through 1979, the Treasury had provided some $15 billion to the cooperatives.

The cost of this borrowing doesn't show up in the federal budget, a practice that has been criticized by David Stockman, Reagan's budget director, and by the General Accounting Office, the congressional investigating agency.

ONCE UNTOUCHABLE

Rural electric cooperatives were considered politically untouchable until late in 1979, when the Environmental Policy Institute issued a 750-page report titled, "Lines Across the Land."

The institute decided to undertake the study of the system when the National Rural Electric Cooperative Association successfully lobbied in 1977 against some of the more stringent environmental standards in proposed strip mine legislation.

Jack Doyle, the study's author, stated that while rural electrification began as a "progressive, populist movement" designed to help lift rural people out of the poverty of the 1930s, "today, rural electrification is losing its connection with the land and is turning away from the farmer."

For one thing, the study noted, rural electrics increasingly are serving suburban customers, including large industrial and commercial firms.

And instead of concentrating almost entirely on distributing electricity, the systems are engaging in large-scale power generation, involving the partnerships with private utilities and membership in multi-state transmission grids.

The Doyle study and the Reagan administration both have noted that low-cost federal money increasingly has gone to those cooperatives set up to generate power. The report emphasized that the joint ventures with private companies have destroyed the traditional role of the rural system in providing a service standard against which the investor-owned companies could be measured.

"ANTI-ENVIRONMENTAL PHILOSOPHY"

The report stated that "the entire rural electric hierarchy . . . is arrayed in almost constant opposition to environmental laws and programs, and this anti-environmental philosophy is reflected in the co-ops' national platform, in their advertising, in their editorials, in their lobbying at the state and federal levels and in their legal interventions and lawsuits."

But perhaps the most stinging criticism was that control of the system had effectively been usurped by its managers and by virtually self-perpetuating boards of directors of individual cooperatives.

The study charged that some co-ops routinely deny information to their members and limit access to meetings at which major decisions are made. It contended that many important decisions about investment and expansion are made by management and that local boards of directors are, in effect, compelled to go along.

Many of the charges have been denied by the National Rural Electric Cooperative Association, which is supported by member cooperatives and also serves as the industry's lobbying group.

SOME BOARDS "TOO ENTRENCHED"

But Robert Nelson, a spokesman for the association, does acknowledge that "all of us have been critical of some" cooperatives. "Some old boards of directors," he said, "did get a little bit too entrenched."

But Nelson and other association officials say the rural system continues to be a leader in energy conservation and in pushing solar and wind power, and he noted that the system's annual increase in demand, which had been 10 percent, now is down to about 3 percent or less.

The association called the Doyle study "an astonishing document," produced by "a group of environmental idealists opposed to cooperative growth in providing central station electricity." It contended the study was "naive, irresponsible and biased."

The administration has estimated that by eliminating the $37.5 billion the co-ops probably would borrow through 1986, the government would save about $427 million in interest subsidies.

Officials have estimated that co-op customers in many areas currently pay up to 12 per cent less for electricity than do many urban customers of privately owned utilities. In these cases, they say, the higher costs associated with commercial borrowing can easily be passed on to customers. In some rural areas, though electricity customers already are charged rates comparable to those in urban sections and the administration's plan will mean significantly higher charges, officials have conceded.

Still, the Congressional Budget Office has concluded, "Rural customers, as a group, are no longer economically disadvantaged relative to all other customers."

SIMPLE STATISTICS

The cooperative association believes some simple statistics explain why the government should continue to help provide power in rural areas. For example, rural systems average 4.6 consumers per mile of line, while investor-owned utilities average 35.8 customers per mile. And, it says, revenue per mile of line for the co-op system is $2,887, while the private firms get an average of $36,652.

Robert Partridge, executive vice president of the association, asks why anybody would want to change a system that is "working extremely well."

"We simply will not stand for the erosion of a program which so demonstrably is basic to our nation's prosperity."

This week, members of Congress and the Reagan administration will find out first-hand just who he means by "we."

[Reprint from the Dallas Morning News, Sunday, May 2, 1982]

Utility Challenges Federal Agency in N-plant Dispute

(By Bill Lodge, Staff Writer of The News)

A Beaumont-based utility company has challenged a federal agency by going to the office of Vice President George Bush with a dispute over reduced federal funding for the utility's nuclear power plant.

Gulf States Utilities Co. complained in an April letter to Bush about a refusal by the U.S. Rural Electrification Administration to provide a minimum of $125 million in loan guarantees for a Texas cooperative attempting to purchase 7 percent of the atomic unit.

GSU's action lends support to the suspicions of REA watchdogs, including the Washington-based Environmental Policy Institute, that some REA loan guarantees to customer-owned cooperatives actually have been bailouts for investor-owned utility companies that have not properly managed the construction of nuclear power plants.

"The eyes of Texas, and the world, are on its favorite son, George Bush, and if he reverses this decision it will run counter to everything that they're (the Reagan administration) talking about in terms of fiscal responsibility," said EPI staff member Jack Doyle.

Traditionally, the REA has provided funding assistance for power-plant construction only to cooperatives serving rural areas. But GSU has actively lobbied the REA for approval of loan guarantees for its project.

Doyle said GSU's action "borders on an impropriety. It should be investigated by somebody in Congress. What the hell is an investor-owned utility doing at the REA?

REA guarantees generally are coupled with loans obtained from the Federal Financing Bank at below-market interest rates.

But developments in the Beaumont dispute indicate REA is taking a tougher look at cost overruns in the construction of nuclear plants.

Now, GSU is asking Bush to pressure REA to reverse its refusal to provide loan guarantees for a Texas electric cooperative attempting to buy an interest in GSU's River Bend nuclear power plant in Louisiana, about 25 miles north of Baton Rouge.

The cooperative, Sam Rayburn G&T Inc. of Jasper, agreed in 1979 to purchase 7 percent of the first of two 940-megawatt atomic units at River Bend for a minimum of $125 million. That unit originally was expected to cost less than $400 million, but its price had increased to $1.7 billion by 1979 and now is estimated by GSU at $3.1 billion—an indication that Sam Rayburn's share would be more than $200 million.

GSU officials previously reported that completion of River Bend was not contingent upon REA support for Sam Rayburn and a Louisiana cooperative buying 30 percent of the plant. But GSU is now saying that lack of federal support could significantly increase costs to its 500,000 customers in Texas and Louisiana.

GSU president Norman Lee lobbied REA for approval of Sam Rayburn's request for loan guarantees. When those efforts failed, Lee wrote the complaint to Bush.

Bush is out of the country, but a member of his staff said he probably will not comment on the matter immediately when he returns later this month.

The employee also said that a staff member has been directed to question REA officials about the GSU-Sam Rayburn matter.

Although Lee implied in his letter to Bush that REA's refusal to provide loan guarantees for Sam Rayburn is jeopardizing the River Bend project, GSU spokesman Kim McMurray denied that is the case.

McMurry said the project will be completed with or without Sam Rayburn's participation, but that loss of the federal guarantees "would certainly make it more difficult for us to finance it, and it would cost customers more" because financing costs would be increased.

McMurray quoted REA deputy administrator Jack Van Mark as saying, "We believe the uncertainty associated with construction and operation of nuclear plants and the magnitude of investment associated with the plants outweigh any advantages that the ownership might offer" to cooperatives.

Van Mark said REA is not opposed to the use of nuclear power but that owners of nuclear plants must demonstrate that they are economically feasible before they can expect additional financial support from the federal government.

"We're in favor of nuclear power, but the plain-out truth is they're (nuclear plants) just prohibitively expensive," Van Mark said.

Although REA has cut in half the requested loan guarantees for what was to have been a 4.33 percent ownership in Comanche Peak by San Augustine-based Tex-La Electric Power Cooperative of Texas Inc., the Dallas-based major owners have no immediate plans to join GSU in its fight with the federal agency.

Major owners—Dallas Power & Light Co., Texas Power & Light Co. and Texas Electric Service Co.—have a significant difference of opinion with REA over the estimated cost of Comanche Peak.

The owners say the plant will be completed in 1985 at a cost of $3.44 billion. REA contends the price will be $5 billion. Originally, Comanche Peak was to have been completed in 1981 at a cost of $779 million.

RESPONSE TO POINTS RAISED BY SENATOR ALAN K. SIMPSON (R-WYOMING) IN HIS MAY 3, 1984 LETTER TO SENATOR PAULA HAWKINS (R-FLORIDA)

SUBMITTED BY ANGUS HASTINGS, CLAY ELECTRIC CO-OP OF FLORIDA

GENERAL COMMENTS

The letter clearly and frequently tries to establish the idea that the "trade associations," and the actual leadership of the rural electric and telephone programs, are not, in fact, one and the same people. To the contrary, NRECA and the rural telephone organizations are as close to being grassroots driven as any trade or service organization can be. NRECA policies are established by its members through an open resolutions process. The association's major goals and priorities are set by an elected Board of Directors. In many ways, the governing process of NRECA is closer to the ideal of true participatory democracy than even that embodied in the Congress of the United States.

The program leadership at the state and local level is comprised of the very "salt of the earth types" to which the Senator refers: "the farmer, the rancher, the small businessman, the guy that really makes America hum," as he describes them. These program leaders have universally endorsed the provisions of S. 1300/H.R. 3050 through resolutions they have passed at the local, state and national levels. Further, several thousand of them are "voting with their feet" by coming to Washington this week to express organizational and personal support for the measure.

In focusing his attention on the alleged gulf between what the people want and what the "trade associations" advocate, does the Senator mean to imply that the elected leaders of the rural electric and telephone program have been derelict in meeting their responsibility as officers and directors to be fully informed on issues of importance to their cooperatives?

In describing to the complexity of the REA financing system as sufficient to "make an atomic scientist blanch," does he mean to say that this issue is somehow beyond the comprehension of these co-op directors and other program leaders?

Does the Senator believe that the "very fine citizen constituents" of whom he speaks are so gullible that 100% of them have been taken in by the "trade associations" and have been blindly marching to a tune played in Washington for the past three years?

POINT: ". . .the effort had been largely completed -- when over 99 percent of rural America then received electrical energy -- then some very creative financiers, accountants, lawyers and businessmen entered the fray" (page one).

> RESPONSE: Congress designed and created the present lending program through enactment of Public Law 93-32 in May of 1973, and even then the "99 percent completed" argument was in wide use by those who opposed continuation of the REA program. Legislators understood then -- as most do now -- that the need for capital investment by rural electrics will continue even after all of those who want electric service are able to get it. Investor owned utilities that serve New York, Chicago and other areas where the job of providing service has been 100% complete for decades continue to borrow and invest billions of dollars annually in expansion and improvement of their systems. So it is with rural electrics. Like all utilities, they must have a continuing flow of new capital. Unlike other utilities, they serve areas with revenues and consumer density far below average, and therefore still need a measure of assistance provided through REA.
>
> It's worth recalling also that the "creative financiers, accountants, lawyers and businessmen" responsible for creation of the present REA financing system were people with such names as former Wyoming Senator Clifford Hansen, Senators Howard Baker, Bob Dole, Ted Stevens, James McClure, Strom Thurmond, and many of their former colleagues such as Senators Carl Curtis, Roman Hruska, Milton Young, and Hubert Humphrey along with many other highly respected congressional leaders from both political parties. The bill was also, it should be noted, signed into law during the Republican Administration of President Richard Nixon.

POINT: ". . .this 'self sufficiency' bill really does not compare in any way to what your constituents may have been informed." (page two); "I deeply believe that the trade associations have consciously or unconsciously misled the public about what this bill really does. And maybe they have been doing that for years." (page five); ". . .inform them on some of the facts that the trade associations have withheld from them." (page six).

RESPONSE: The assertion that "constituents" or the public-at-large have been misled or had information withheld from them -- deliberately or otherwise -- is just not consistent with the record. NRECA and the organizations of telephone borrowers have expended tremendous amounts of time and energy to see that everyone involved with the program, from the individual consumer-member on up, is fully informed about what is proposed in S. 1300/ H.R. 3050. NRECA's Committee on Financing for the Future held open hearings throughout the nation to gain member advice and input even before the actual concepts behind the measure were fully formulated.

Discussion of the financing proposal has been a prominent feature of every NRECA regional and annual meeting for the past two years. In addition, just prior to the introduction of the legislation in May of 1983, NRECA held a series of eleven special meetings throughout the country to give program leaders and activists a full and complete briefing on every aspect of the measure.

Details of the origin, the content, the anticipated effect and the progress of this legislation have been covered extensively in the publications of NRECA and the rural telephone organizations -- including coverage of the key arguments put forth by those opposed to the bill. If the Senator has evidence to show that NRECA or the other trade associations have published factually false or otherwise misleading information about the proposal, he should bring it forward and give us a chance to respond.

POINT: "We surely didn't get to this point of distress overnight and there is absolutely no cogent reason to be rammed into action at this particular moment of the legislative year" (page two).

RESPONSE: No, we did not get to this point of distress overnight, but it's clear that the longer the problem is neglected, the more difficult and painful will be the solution. Further, there is no good reason why Congress should not take prompt action to correct the imbalance and other problems of the REA loan program. The nature of the problem is well understood. A solution has been proposed and has been pending before the Congress for more than a full year. Nothing is being "rammed into action." The fact that we have reached the eleventh hour of this session of Congress without final action on this bill is not due to the wishes of its supporters, but rather is a result of the delaying tactics of those oppose the bill.

POINT: "This bill was not drafted by objective parties. . .it is proposed to really serve the special interest groups that will benefit most from it." (page two).

RESPONSE: How many bills before the Congress are drafted by "objective parties?" Those responsible for drafting and introducing this bill were admittedly not objective in the sense that they did so out of a belief that REA financing and the rural electrification program should be preserved to meet the needs of the future. Insofar as the bill's serving "special interest groups," we'll plead guilty to this also, in that helping to preserve a strong agricultural sector and competitive economic environment in rural America will serve the "special interest groups" comprised of those who eat food grown on America's farms, who wear clothes made from fiber grown on America's farms, or who live in homes made from timber harvested in the rural areas of our nation. S.1300 also will benefit the "special interest group" of 25-million rural Americans who depend on REA financed systems for electric service at affordable rates, along with the 215-million urban and suburban Americans whose cities and towns would be even more crowded were it not for the rural economic development made possible by electric and telephone service.

POINT: ". . .this 'forgiveness' will cost the taxpayers literally billions of dollars. You might wish to ask your banker for this kind of an 'equity transfer' on your home mortgage." (page three)

RESPONSE: The funds involved in this transfer will never be out of the direct control or ownership of the Congress and government of the United States. The notes involved were made available by Congress in 1973 to serve as the "seed capital" for the revolving fund. If interest rates had remained at the 1973 levels during this past eleven years, it would be no problem for Congress follow through on its original plan to gradually siphon off this seed capital starting in 1993. But interest rates did not remain stable, as we all know, and the fund still needs this foundation of financial strength if it is to meet the future needs of the program. If interest rates in future years are lower and more stable than in the recent past, it's reasonable to expect that the strength of the fund will increase and this seed money can be transferred back to the Treasury at that time. Since we have no way to know when, or if, these conditions will exist, S. 1300 proposes that this seed capital remain in the revolving fund for as long as Congress believes it should be there.

It also should be noted that in none of the so-called "cost" figures attributed to S. 1300 has any consideration been given to the substanitally increased revenues that would flow to the government-owned revolving fund as a result of the increased REA interest rate under the bill. This increase in interest revenue could, under future economic conditions projected by the Congressional Budget Office for example, amount to several billions of dollars.

We know, of course, what a banker would say to a proposal for an "equity transfer" on a home mortgage. We know also, however, that the conversion of debt to equity is a common practice in business. Many corporations issue instruments of debt in the form of convertible bonds which, at some future date, are converted into equity in the form of common stock in the company. No one considers this conversion to be "forgiveness" on the part of the bondholders -- nor should they.

POINT: ". . .rates under this bill will be too low to prevent RETRF insolvency. Thus the bill really perverts the honest willingness of reliable borrowers to pay rates that are actually high enough to preserve the RETRF. . . . The amended formula might have the possibility to work in theory. . ."

RESPONSE: Using the Administration's own budgetary projections for future interest rates, the computer models developed by both NRECA and REA indicate that the formula in the bill will work as intended. If the model is based on a sustained period of very high future interest rates and high levels of REA lending, however, there is evidence that the REA rate formula, as contained in S. 1300, could fail to bring about long-term stability to the fund. This is the reason that NRECA agreed to and endorsed the amendment offered to the House bill by Representative Charles Stenholm which will ensure that balance is achieved under any conditions.

Spokesmen for the CBO, GAO and others who testified at the most recent hearing on the Senate bill agreed that with the addition of the Stenholm language, the interest rate formula in the bill will accomplish its purpose.

We agree fully that the REA borrowers are willing to pay rates high enough to preserve the RETRF. They are not, however, willing to pay rates that are needlessly higher than that amount, as was proposed in the House floor amendments by Mr. Bethune, and in the proposed legislation sent to Congress several weeks ago by Agriculture Secretary Block.

POINT: . . .modeling of the House formula amendment shows that rates will be erratic, unpredictable, and quite subject to manipulation." (page three)

RESPONSE: Since the REA interest rate will be indirectly tied to the overall cost of money, it will clearly be no more nor less predictable and erratic than interest rates in general. Insofar as its being subject to manipulation, this may be true, but only to manipulation by the Administration in power, through the actions of the REA Administrator. One would hope that the process of congressional oversight would prevent abuses in this regard.

POINT: "All of these 'forgivenesses' only reduce RETRF rates by two percent or less." (page three)

RESPONSE: Two percent on a billion dollars in loans is $20-million per year (or roughly $400-million over the 35 year term of the loan) of additional interest expense that would flow through to the people of rural America who, according to REA's own data, are already paying an average of 14% higher electric rates than their neighbors served by non-REA financed utilities.

POINT: ". . .supporters of the measure say that these refinancings won't cost anything because Treasury won't permit them. Well if they won't be used, why not let's toss them out now?" (page four)

RESPONSE: This is not precisely what we've said. Since the provisions in S. 1300 would require that the FFB and Treasury fully agree to any refinancing of REA's CBOs or REA guaranteed loans, we would not expect them to refinance unless they determine it would not disadvantage them to do so. This could happen in the future if, for example, a sustained period of lower interest rates resulted in the government's blended cost of money being substantially lower than the long-term rate applied to some outstanding CBOs. In these circumstances, Treasury and FFB could share in the benefit of these reduced market rates by agreeing to refinance some of the REA and rural electric notes. We believe the door should be left open for this possibility.

POINT: ". . .54 co-ops. . .had 50 percent or more of their consumers living in Standard Metropolitan Statistical Areas."

RESPONSE: It's true that population growth in some areas has caused portions of some co-ops to become "non-rural" in character. But even the co-ops in the highly developed areas outside of Atlanta, Washington, D.C., Minneapolis, and elsewhere have consumer density only one-third or less than that of the average investor-owned utility. And because these systems are the fastest growing, they tend to have the greatest need for new capital and would be affected most by increased interest rates.

POINT: "They are telling you or me that we dare not oppose any part of this legislation or question it or try to improve it. . ."

RESPONSE: S. 1300 has been pending before the Senate for more than a year. NRECA and other supporters of the bill have repeatedly invited those who oppose all or part of the bill to come forward with alternative proposals. None have done so until the past few weeks when, with only a very short time left in this Congress, the Administration has come forward with a proposal that would, in essence, terminate the effectiveness of REA as a source of capital for rural electrification.

POINT: ". . .but I really balk when I see REA's peddling power to substantial corporations. One co-op in my home state had 1982 power sales of 386,000 megawatt hours -- and 354,000 of those hours (91.7%!) were sold to large industrial and commerical users and yet that co-op still qualifies for 2% REA loans." (page five)

RESPONSE: What is the alternative being proposed? That "substantial corporations" should not be allowed to locate in rural areas served by REA financed systems. Or that investor-owned utilities be allowed to provide direct service to large industrial or commercial consumers in co-op territories, thereby keeping the co-ops small, 100% farm and residential, and inevitably high cost operations?

The Wyoming cooperative to which the Senator refers (Hot Springs County Rural Electric Association) serves a number of mines and oil pumping facilities which are classified by REA as industrial and commercial users. Overall, however, the cooperative serves only 3,505 consumers, with an average density of just 1.74 per mile of line. It rates are higher than that of the neighboring investor owned utility.

Because the system has fewer than two consumers per mile, it previously qualified for REA special rate financing at two percent. Since 1981, however, the special rate program has been entirely discretionary and no borrower "qualifies" for two percent loans.

POINT: . . .for now we are being "advised" that we have to think and vote the way the paymasters of an extraordinarily generous P.A.C. fund will tell us."

RESPONSE: The rural electric political action program, ACRE, bases its support on the very clearly stated premise that we support those who support rural electrification. This is understood at the time contributions are solicited from ACRE by candidates; it's understood at the time the contributions are accepted, and if its a problem, no candidate is forced to accept support from ACRE or any other political action committee, for that matter.

POINT: "When that first CBO comes due I hunch we will be asked for another simple conversion of "debt" into "equity." (page six)

> RESPONSE: The near fifty year history of the rural electric program provides no basis for this kind of accusation. The rural electrics have a long record of responsibility in their dealings with government, and have never been a group that asks anything more than that which is needed to do the job we've been given to do. To imply otherwise without cause or evidence is not only unfounded, it's unfair.

POINT: "I would sincerely urge you to work with me to develop a reasonable, honest and fair alternative to S. 1300 that will keep those rural lights burning without searing the taxpayers' pockets for a long time to come." (page six)

> RESPONSE: Where were you, Senator, three months, six months or a year ago -- when there were more than 30 legislative days in which to achieve such an alternative?

POINT: "I get lots of dazzling flack from the trade associations -- but no answers." (page seven)

> RESPONSE: We stand ready to give you any and all the answers you want -- any time, any place -- just as we have since the introduction of S. 1300 in May of last year.

# # #

NRECA RESEARCH
May 8, 1984

IMPACT ON ELECTRIC RATES OF ADMINISTRATION'S PROPOSAL AND S.1300

Name of Cooperative Clay Electric Cooperative, Inc.

IMPACT OF ADMINISTRATION'S PROPOSAL COMPARED TO CURRENT LAW

1. Amount of REA loan[1]	$ 9,542,000.00
2. Annual interest expense under current law (REA 5%) (.05 x line 1)	$ 477,100.00
3. Annual interest expense under Administration Proposal[2] (REA 13% est.) (.13 x line 1)	$ 1,240,460.00
4. Additional interest expense under Administration Proposal (line 3 - 2)	$ 763,360.00
5. Additional margins required to maintain 2.0 TIER[3] (same amount as line 4)	$ 763,360.00
6. TOTAL increase under Adminstration Proposals (line 4 + 5)	$ 1,526,720.00
7. Number of consumers served	$ 78,281
8. Annual increased cost per consumer (line 6 ÷ 7)	$ 19.50

IMPACT OF S.1300 COMPARED TO CURRENT LAW

9. Annual interest expense under S.1300 (REA 6.5% est.) (.065 x line 1)	$ 620,230.00
10. Additional interest expense under S.1300 (line 9 - 2)	$ 143,130.00
11. Additional margins required to maintain 2.0 TIER (same amount as line 10)	$ 143,130.00
12. TOTAL increase under S.1300 (line 10 + 11)	$ 286,260.00
13. Annual increased cost per consumer	$ 3.66

ADDITIONAL COMMENTS

1. Clay Electric's density at present - 9.6 per mile.

   If Co-ops with 10 or more consumers per mile are excluded, we would be excluded by next year.

2. Clay's rates are higher now than all neighboring utilities - I. O. U. AND Municipal.

NOTE: These increases reflect one REA loan only; the increases will compound as additional financing is required.

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[1] Amount of last REA loan approved, or loan application pending or planned.
[2] REA rate = cost of money and user fees.
[3] Times Interest Earned Ratio (TIER) must be maintained as interest costs increase.

CLEARING THE DEBT OF THE RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND: AN ECONOMIC ANALYSIS OF LEGISLATION BEFORE THE 98TH CONGRESS

By Sylvia Morrison[1]

ISSUE DEFINITION

The Rural Electrification and Telephone Revolving Fund (RETRF) is projected to show a negative balance in its cash flow by 1986. This trend toward a negative projected cash flow results from lending limits stipulated in annual appropriations bills. To finance the difference, the Fund borrows from the Treasury at market interest rates which have averaged more than 9 percent. The rate at which the Fund lends, however, is capped by law at 5 percent. Hence the gap between income to the Fund and disbursements from the Fund has grown continuously and will continue to do so until changes are made. If no changes are made by the year 2006, the Revolving Fund is projected to run out of money.

Current legislation addresses two fundamental issues. First is whether the gap in the Fund should be made up by additional contributions from the Treasury, or by increased payments from cooperative consumers, or by some combination of these two. Second is whether to restore full solvency to the Fund by assuring it enough income to service both its short and long-term obligations or to just prevent the Fund from running out of money in the immediate future by paying only the Fund's current obligations.

BACKGROUND

The rural electrification program was established in 1935 both to bring electricity to American farms and to create employment. When the rural electrification program was begun, fewer than 12 percent of U.S. farms were receiving electric service because many private companies refused to make unprofitable investments in service to isolated areas. By 1982, the Rural Electrification Administration (REA) had underwritten the establishment of more than 1,100 locally organized and managed rural electric cooperatives. These serve nearly 10 million households and businesses and have brought the percentage of rural households and businesses receiving electric service to 99 percent.

Until 1973, loans to rural electric borrowers were made directly from the Treasury, subject to REA evaluation and approval. In 1973, Congress replaced this system of direct Treasury loans by establishing the Rural Electrification and Telephone Revolving Fund (RETRF) under the administration of the Rural Electrification Administration of the U.S. Department of Agriculture. Congress capitalized the Revolving Fund by lending it, as temporary assets, $7.9 billion in notes from rural electric cooperatives to the Treasury, and by granting to the Revolving Fund all of the interest that would be paid to the Government on these Treasury loans of the past, as well as all principal and interest that would be paid into the Fund for loans it would make in the future.

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[1] Congressional Research Service, Library of Congress.

Congress set 5 percent as the standard interest rate for Revolving Fund loans, a rate which was very close to the Treasury rate in 1973. Congress also set a special interest rate of 2 percent for hardship cases.

In the decade following the 1973 establishment of the Revolving Fund, Congress each year set ceiling levels for the REA lending program that ranged between 167 percent and 253 percent of the amounts the Fund was receiving as payments on past loans, as shown in Table 1.

Table 1. Receipts and Disbursements of the Rural Electrification and Telephone Revolving Fund, 1973-1982.

(dollar amounts in millions)

Year	Receipts	Disbursements	Disbursements as Percent of Receipts
1973	$ 41.7	$ 92.4	222 %
1974	317.3	802.4	253
1975	378.3	854.9	226
1976	551.5	1037.6	188
1977	510.1	904.5	177
1978	571.2	918.3	161
1979	610.7	1184.3	194
1980	686.0	1350.9	197
1981	745.8	1432.2	192
1982	815.1	1364.5	167

Source: Rural Electrification Administration, U.S. Department of Agriculture. Audit Report: Loan-Making Policies for Electric Distribution Cooperatives, 1983. p. 14.

To have available for lending the full amount of money Congress had authorized it to lend, the Revolving Fund began in 1976 to borrow from the Department of the Treasury's Federal Financing Bank. The mechanism used to make loans from the Federal Financing Bank (FFB) to the Revolving Fund is a special kind of bond which is backed by rural electric cooperative notes and called a Certificate of Beneficial Ownership (CBO). When borrowing from the Federal Financing Bank, the REA sells Certificates of Beneficial Ownership to the Federal Financing Bank. It then lends the fund it receives to rural electric cooperatives. CBOs are sold at the interest rate at which the Treasury borrows, plus one-eighth of one percent.

Between 1976 (the first year when the Revolving Fund sold CBOs to supplement its income) and 1982, the Treasury rate averaged 9 percent. In the period when the RETRF was borrowing approximately half of its disbursements at an average rate of 9 1/8 percent and lending approximately double its receipts at an average rate under 5 percent, a gap between income and disbursements from the Fund developed. It is this gap which the proposed legislation addresses.

The Major Problem Is How to Pay the Revolving Fund's Financial Obligations

Any legislation that addresses the gap in the Revolving Fund confronts the fact that the Revolving Fund has three kinds of obligations to the Treasury:

- $7.9 billion the Revolving Fund borrowed from the Treasury as start-up money, due to be repaid beginning in 1993;
- $3.5 billion the Revolving Fund borrowed from the Treasury over the last decade through sales of Certificates of Beneficial Ownership (CBOs), due to be repaid beginning in 2006;
- interest on the $3.5 billion borrowed from the Treasury through sales of CBOs, due every 6 months.

Two types of legislation, which take different approaches to the three kinds of obligations, have been introduced to remedy the Revolving Fund's shortage of cash.

Major Provisions of S. 1300/H.R. 3050 and Anticipated Effects

The first legislation to address the Fund's potential insolvency, H.R. 3050, was passed by the House of Representatives on March 1, 1984. Its companion bill, S. 1300, is now before the Senate. S. 1300 and H.R. 3050 clear the Revolving Fund's $7.9 billion debt to the Treasury by forgiving it.

S. 1300 and H.R. 3050 do not address the second kind of debt: that is, the $3.5 billion the Revolving Fund has borrowed from the Treasury over the past 8 years by selling it Certificates of Beneficial Ownership. Present law provides that the Revolving Fund shall begin to make repayments on the CBO debt when the first CBOs (sold in 1976) mature in 2006. The CBO debt is now $3.5 billion. By 2006, under the terms of H.R. 3050 and S. 1300 (which do not limit the size of the REA program) the CBO debt is likely to be considerably larger.

Sponsors of S. 1300 and H.R. 3050 explain that no provision is made to repay the (now) $3.5 billion CBO debt because it is intended that the Revolving Fund will sell new CBOs to the Treasury in order to make payments of principal on the original CBOs as they fall due.

S. 1300 and H.R. 3050 deal with the third kind of obligation--payments of interest due to the Treasury every six months on the $3.5 billion CBO debt--by raising the interest rate the Rural Electrification Administration charges to distribution cooperatives on construction loans to whatever interest rate is necessary in any year to bring in enough revenue to pay the interest due.

If the $3.5 billion borrowed from the Treasury between 1976 and 1984 (which S.1300 and H.R. 3050 make no provision to repay) is taken together with the $7.9 billion debt to the Treasury for the Fund's initial capitalization (which S. 1300 and H.R.3050 forgive), the legislation appears to open the door for the Revolving Fund to avoid the payment of principal on obligations to the Treasury of at least $11.4 billion.

Non-payment by the Revolving Fund of its borrowings from the Treasury would have two primary effects: it would maintain the pool of funds available for lending to cooperatives at a subsidized rate, and would reduce the amount of potential funds flowing into the Treasury and possibly force it to borrow the funds previously due to it but not repaid.

REA modeling efforts show that the interest rate to electric cooperative borrowers that S. 1300 and H.R. 3050 would put into effect would vary from year to year in a cyclical pattern. As table 2 shows, the range of the cycle over the next 20 years would be from 5.29 to 10.48 percent, averaging 8.4 percent. However, as table 2 also shows, from 2004 to 2024--the second twenty years--the interest rates S. 1300 and H.R. 3050 would charge borrowers would range from 7.10 percent to 12.02 percent, averaging 9.4 percent. In short, S. 1300 and H.R. 3050 distribute the burden of servicing the current Revolving Fund obligations first by cancelling or rolling over loans from the Treasury, second by raising interest charges to consumers of the 21st Century, and lastly by raising interest rates for present consumers. [NOTE: These interest rates and all others this issue brief projects assume a Treasury interest rate of 13.55 percent and an electric program of $850 million. If either of these two factors change, the projected rates would also change.]

The effect on electric rates to cooperative customers of the average 3.4 percentage point increase in the Revolving Fund's lending rate would be slight because interest payments by cooperatives to the Revolving Fund are only a 5 percent component of bills to consumers.

Table 2. Projections of Rural Electrification Revolving Fund Interest Rates to be Charged to Borrowers, 1984-2024, under H.R. 3050 (passed) and S. 1300 (reported) Compared with S. 2646, 98TH Congress.
(Electric Program only, in percentages)

Year	H.R. 3050 (as passed) & S. 1300 (as reported) a/	S. 2646 b/
1984	5.29 %	7.44 %
1985	7.71	10.14
1986	8.02	10.82
1987	8.55	11.29
1988	9.10	11.61
1989	10.35	11.71
1990	10.48	11.72
1991	9.57	11.64
1992	8.42	11.55
1993	7.65	11.44
1994	7.66	11.40
1995	8.30	11.31
1996	9.02	11.22
1997	9.33	11.10
1998	9.03	11.13
1999	8.34	11.10
2000	7.74	10.92
2001	7.53	10.69
2002	7.78	10.61
2003	8.22	10.23
2004	8.54	10.07
2005	8.47	10.10
2006	8.08	9.97
2007	10.15	9.29
2008	9.35	9.03
2009	9.91	8.85
2010	12.02	8.18
2011	11.14	7.03
2012	8.81	6.48
2013	7.10	5.28
2014	7.68	5.00
2015	8.74	5.00
2016	10.19	5.00
2017	10.89	5.00
2018	10.18	5.00
2019	8.58	5.00
2020	7.82	5.00
2021	8.29	5.00
2022	9.72	5.00
2023	11.21	5.00
2024	11.84	5.00
2025	11.41	5.00
2026	10.28	5.00
2027	9.15	5.00
2028	8.65	5.00
2029	8.97	5.00

NOTES: TABLE 2.

a/ Assumptions of model for H.R. 3050 (as passed) and S. 1300 (as reported):

Electric program level is assumed to be $850 million each year. Certificate of Beneficial Ownership (CBO) rate 13.35 percent, no repayment of $7.9 billion debt to Treasury, CBO principals not paid at maturity but new CBOs sold to pay them off. Interest income at least equals interest expense in every year. No refinancing downward of CBOs.

b/ Assumptions of model for S. 2646:

Actual rate from 1984-1993 equals standard rate times reduction factor of 80 percent in the first year, 82 percent in the second year, 84 percent in the third year, increasing by 2 percent each year until the tenth year when the full calculated rate is charged. Electric program level is assumed to be $850 million each year, CBO rate 13.35 percent. Revolving Fund repays the Treasury $7.9 billion debt plus principal of CBOs so that by 2018, the Fund's debts are paid in full.

Source: Rural Electrification Administration, July 1984.

Other elements of S. 1300/H.R. 3050 and their anticipated effects

Other elements of S. 1300 and H.R. 3050 are:

- S. 1300 and H.R. 3050 authorize the Administrator of the Rural Electrification Administration, with the approval of the President of the Federal Financing Bank, to reduce the interest rate the Revolving Fund must pay to the Treasury on any outstanding Certificate of Beneficial Ownership that has a remaining term of 7 or more years to the current Treasury rate, when the rate of interest on CBOs sold in the past exceeds the current rate on new certificates by at least 1 percentage point.

-- Anticipated effect: Reducing interest rates on CBOs to rates lower than the rates at which they were sold would reduce the Revolving Fund's interest expenses. Depending at what rate the Treasury borrowed to provide the Revolving Fund with money to lend and whether it, in turn, can refinance its borrowing, the Treasury might lose money by reducing interest rates on CBOs sold at high rates. The bill does not address raising the rates upward if the Treasury rate rises after the refinancing.

- S. 1300 and H.R. 3050 authorize the lender of an REA-guaranteed loan to adjust the interest rate on the loan downward to the current rate if at any time the Treasury rate falls one percentage point lower than the rate at which the loan was made.

-- Anticipated effect: The lender of an REA-guaranteed loan has, to date, without exception, been the Treasury. If the Treasury reduces the interest rate on a loan, it would save the borrowing cooperative money. The Treasury would lose if it, in turn, could not refinance its borrwings.

- S. 1300 and H.R. 3050 specify and expand the eligibility criteria for special (hardship) rate loans, which are to be made at not less than 2 percent or more than one-half the standard rate. The factors that the REA Administrator would be required to include in his evaluation of a cooperative for eligibility to borrow at the special rate would be: consumer electric or telephone rates greater than twice the national average of cooperative rates; average consumer density of 2 or fewer electric meters per mile; financial damage inflicted by natural disasters; low per capita income in the service area; and/or the borrowing cooperative's investment in utility plant per customer at least twice the national average for cooperatives.

-- Anticipated effect: The criteria spelled out in the bill would make eligibility more predictable and less variable as administrators change. It is not clear whether these criteria would make more cooperatives eligible for the hardship interest rate than are now eligible.

- S. 1300 and H.R. 3050 require that the administrator of the REA establish a reserve fund consisting of one percent of all repayments to the electric and telephone accounts during the previous year to cover the cost of making loans at the special rate. If the reserve proves insufficient to cover the costs of all special rate loans, the Secretary of Agriculture would be required to seek an appropriation to cover the deficiency. The term "costs" refers to the difference in annual interest income to the Revolving Fund owing to the lower interest rate on hardship loans.

-- Anticipated effect: In FY 83, the REA Revolving Fund received in payments from its borrowers $866,868,691 of which $8,668,687 (or 1 percent) would have been assigned to the special rate reserve fund, had S. 1300 and H.R. 3050 been in effect. In the same year, the Revolving Fund lent $35,100,000 to electric and telephone cooperatives at the hardship rate of 2 percent. In the first year of the loan, the difference in interest income on $35,000,000 between a loan at 2 percent per year and one at 5 percent per year would have been $1,053,000.

- S. 1300 and H.R. 3050 require the REA to guarantee loans made by any lender approved by the administrator.

-- Anticipated effect: This provision should increase the availability of capital to cooperatives from private sources and make the money available at relatively low rates. Interest rates normally reflect the degree of risk the lender estimates he is undertaking, and a Federal guarantee reduces risk to a minimum.

- o S. 1300 and H.R. 3050 require the REA administrator to subordinate the Federal Government's first lien (give up the Government's first claim) to all the property of a cooperative in case of bankruptcy of a cooperative. The bill requires the administrator to do this at the request of the borrower "for any purposes that would improve the efficiency, effectiveness, or financial stability of the borrower upon a finding that the borrower has, or will have the ability to repay its existing and proposed indebtedness."

- -- Anticipated effect: The intention of this clause in the bills is to encourage private lenders to invest in cooperatives secure in the knowledge that if the cooperative fails, the Federal Government will not seize all the assets of the cooperative preventing the private lender from regaining any of his investment. This provision would appear to be redundant if the REA guarantee of private investments described above is passed. In addition, the standards that would qualify a project for subordination are broad enough to allow great variation among qualifying projects. The legislation does not specify, for example, that the project must be related to supplying electric service.

- o S. 1300 and H.R. 3050 provide that in any year in which the electric loan level is less than $1 billion, the Revolving Fund must lend every borrower at least 70 percent of his approved need at no higher a rate than the standard rate. The REA may grant more liberal terms than these if the administrator deems it advisable.

- -- Anticipated effect: The effect of this provision is to assure a certain base amount of subsidized credit to every cooperative with an approved need regardless of its financial status. This keeps the average rate of interest paid by each cooperative to a minimum, even if the cooperatives are required to borrow part of their funding outside of the Government at higher rates.

S. 2646, an alternative approach

The second legislative approach, embodied in S. 2646, would allow for funds to be generated to cover all three kinds of the Revolving Fund's obligations to the Treasury: the $7.9 billion borrowed for the start-up of the Revolving Fund, the $3.5 billion in principal of the Certificates of Beneficial Ownership (CBO), and all of the interest due on the CBO sales. The program laid out in S. 2646 would allow for the Revolving Fund's obligations to be paid by raising the interest rate the Fund would charge cooperative electric and telephone companies on future construction loans an average of 5.91 percentage points to an approximate average of 10.91 percent over the next 20 years. However, as table 2 shows, in the second 20 years under S. 2646, Revolving Fund interest rates on loans to cooperatives would range from 5.00 percent to 10.10 percent, averaging 6.63 percent. Thus it is seen that in contrast to S. 1300 and H.R. 3050, S. 2646 charges 20th Century customers for debts incurred for construction in this century and 21st Century customers for debts incurred in their own time. [NOTE: These interest rates and all others this issue brief projects assume a Treasury interest rate of 13.55 percent and an electric program of $850 million per year. Changes in either of these two factors would change the interest rate projections.]

S. 2646 would permit the Administrator of the Rural Electrification Administration (REA) to lend those cooperatives that are populous and well-to-do a smaller percentage of their construction capital than the present law stipulates.

Such action would require those cooperatives to borrow a larger portion of their capital from private sources. This would reduce the subsidy the Federal Government would be granting the better-off cooperatives and would raise their average cost of capital above the present level.

Provisions of S. 2646 and anticipated effects

o S. 2646 charges borrowers an interest rate on their construction loans that would cover all of the debts of the Revolving Fund, but reduces rate shock by factoring in the costs incrementally over 10 years.

-- Anticipated effect: The interest rates put into effect by S. 2646 would average 2.5 percentage points higher over the first 20 years than the rates effected by S. 1300. The rates under S. 2646 would, however, maintain a more stable path over time than would the rates under S. 1300. In a program requiring long-term planning and serial loan applications, a more stable level of interest may be of significant value. Over 40 years, the averages of the two interest paths are approximately equal, as S. 2646 pays the obligations of the Fund in the near future. S. 1300 delays payment until the distant future as shown in table 2.

o S. 2646 "levels" (amortizes) the Revolving Fund's CBO payments to the Treasury to include principal as well as interest on loans made to the Revolving Fund in the years 1976-1984.

-- Anticipated effect: Amortization raises current cash requirements for the fund and underlies the higher interest rates to borrowers this bill would impose. It would, however, spare the Fund the expense of borrowing additional funds from the Treasury through CBO sales as cash is needed to pay principal on the original CBOs.

o S. 2646 authorizes the REA administrator to lend Revolving Fund money to borrowers experiencing hardship at a rate lower than but not less than half of the standard rate.

-- Anticipated effect: This provision would replace the present 2 percent interest rate to borrowers experiencing hardship with a rate that would vary with the standard rate but would not be less than 2.5 percent.

o S. 2646 sets a single standard for qualifying for the special interest rate--that the borrower be experiencing "extreme financial hardship."

-- Anticipated effect: This provision would leave the decision as to which cooperatives would receive the hardship rate to the discretion of the administrator. Under this provision, administrators with varying definitions of "extreme financial hardship" would be empowered to impose different standards on the cooperatives, a factor which could bring more uncertainty to cooperative planning.

o S. 2646 would permit the REA administrator to decide what percentage of approved financing the REA would lend the cooperative borrower. In doing so, the administrator would also be deciding what percentage the borrower would have to secure from private lenders.

-- Anticipated effect: This provision would be a change from present law which requires the REA to lend every borrower at least 70 percent of his approved financing at no more than the standard rate regardless of whether a cooperative can demonstrate need. It is in response to Department of Agriculture data which show that many cooperatives borrowing from the RETRF are neither poor nor rural. It would permit the REA administrator to direct the bulk of the available funds to those cooperatives, which because of sparse population, low-income population, storm damage, inaccessibility, or other hardship factors need subsidized rates. The proposed change would, however, give the REA administrator more discretion in distributing funds and would probably raise the average cost of capital for some of the better-off cooperatives.

o S. 2646 caps the annual lending authority of the Revolving Fund at $850 million for the electric cooperatives and $250 million for the telephone cooperatives for all future years unless new legislation should raise the cap.

-- Anticipated effect: This provision would limit total lending and create an incentive to borrowers to keep loan requests to those most necessary. It would have this effect because a high volume of borrowing by cooperatives would result in the borrowers competing for any funds requested beyond the cap in the private capital market where interest rates are considerably higher than those of the Revolving Fund. The overall effect would be to raise the average cost of borrowing to the cooperatives if their borrowing level increased. This provision would tend to save the Federal Government money, but might result in some needed projects not being completed.

Comparing the Effects of S. 2646 and S. 1300/H.R. 3050

Table 3 compares the provisions of S. 2646 and S. 1300/H.R. 3050. Generally, it can be said that S. 2646 would reduce future Federal subsidies to the cooperatives with the probable result that unless the cooperatives reduce their construction programs, they would pay a higher rate of interest for their construction capital than they would if S. 1300 and H.R. 3050 were enacted. On the other hand, S. 2646 appears to be considerably more likely to restore solvency to the Revolving Fund without the Treasury having to cancel loans. The provisions of S. 2646 would cost the Treasury less but the Revolving Fund and the cooperative consumers more, at least in the immediate future, than the provisions of S. 1300 and H.R. 3050.

S. 2646 also grants the administrator of the REA considerably greater use of his discretion in distributing available subsidized funds than does the current 70-percent rule. S. 1300 and H.R. 3050, by contrast, would fix the 70-percent rule permanently in place. This rule distributes the available REA funding more or less evenly among the cooperatives regardless of their financial status. However, the provisions of S. 2646, which do not spell out specific criteria by which the administrator is to distribute funds, give the administrator discretion to distribute the funds according to need or other criteria. Under S. 2646, the administrator also retains wide discretion in alloting low-interest hardship loans, whereas S. 1300 and H.R. 3050 provide specific criteria for allocation of hardship loans.

Basically, however, the two bills differ in their answers to the two fundamental questions: Shall taxpayers or cooperative customers pay the bulk of the debt accumulated from 10 years of deficit financing? And, for the portion cooperative customers should pay, shall it be mainly present or future customers? S. 2646 charges customers enough to pay all three kinds of Treasury obligations on time. S. 1300 and H.R. 3050, would cancel repayment of $7.9 billion in debt and charge the cooperative customers only for the interest on the CBO debt of $3.5 billion. The formula prescribed by S. 1300 and H.R. 3050 places the major burden of the portion of payment to the Treasury that customers will pay on customers of the 21st Century. S. 2646 puts that burden immediately on present customers.

The main focus of S. 1300 and H.R. 3050 is to maximize money, both private and Federal, that will be available for loans over the next 20 years to cooperative borrowers at the lowest feasible interest rates.

It does so by forgiving the debt of $7.9 billion to the Treasury, by allowing for refinancing to reduce the interest due on outstanding CBOs and guaranteed loans, by requiring the Secretary of Agriculture to request an appropriation for the Revolving Fund for hardship loans if the interest income lost on them amounts to more than 1 percent of the Revolving Fund's revenues, by requiring the administrator to subordinate the Federal Government's first lien on cooperative property, and by requiring the administrator to guarantee the loan of any lender he approves.

The focus of S.2646, on the other hand, is to make the Revolving Fund financially sound by requiring ratepayers and cooperatives that are financially well off to pay a greater portion of their own costs within the next 25 years. In its attempt to do so, S. 2646 relies basically on its formula for calculating interest rates, amortized payments of Revolving Fund debt to the Treasury, a limit on program size which effectively limits the amount of subsidized funding, and, upon the discretion of the REA administrator.

TABLE 3. Comparison of the Provisions of S. 1300/H.R. 3050 with the Provisions of S. 2646, 98th Congress.

	Subject	S. 1300/H.R. 3050	S. 2646
1.	$7.9 billion loan to Revolving Fund from Treasury for initial capitalization	Forgives	Repays
2.	CBO principals	Not addressed. Assumes new CBOs will be sold to pay for originals as originals fall due.	Repays on amortized schedule with interest
3.	Interest on CBOs	Repays as due.	Repays on amortized schedule along with principal
4.	Standard interest rate charged to cooperatives	Averages 8.4% over first 20 years and 9.46% over second 20 years if Treasury rate is 13.55% and electric program is $850 million annually (1984 level). Varies cyclically.	Averages 10.91% over first 20 years and 6.63% over second 20 years if Treasury rate is 13.55% and electric program is $850 million annually (1984 level). Path is relatively stable.
5.	Limit on amount to be lent annually.	No limit	$850 million for electric cooperatives and $250 million for telephone cooperatives
6.	Cost to the Treasury	Depending on CBO rate and program size, at least $7.9 billion.	Administrative costs of the program only
7.	Supplemental financing ratio	REA required to lend at least 70% of each approved loan.	REA Administrator's discretion

Table 3. Comparison of the Provisions of S. 1300/H.R. 3050 with the Provisions of S. 2646, 98th Congress (continued).

	Subject	S. 1300/H.R. 3050	S. 2646
8.	Special (harship) interest rate to cooperatives	2% interest rate. Secretary of Agriculture required to request appropriations for the Fund if interest loss on hardship loans exceeds 1 percent of Fund receipts.	1/2 standard rate but not less than 2.5%.
9.	First lien subordination	Requires REA Administrator to subordinate Federal first lien on cooperative property to encourage private investment	Not addressed
10.	Reduces interest rate Revolving Fund must pay on CBOs to match Treasury rate when Treasury rate is at least one percentage point lower than CBO's rate.	Included	Not included
11.	Reduced interest rate borrowers must pay on guaranteed loans from FFB to match Treasury rate when Treasury rate is at least 1 percentage point lower than loan rate.	Included	Not included

Source: Sylvia Morrison, Analyst in Industry & Finance, Economics Division, Congressional Research Service.

(The material on the following pages was supplied by Senator Hawkins:)

United States Senate
WASHINGTON, D.C. 20510

May 3, 1984

Honorable Paula Hawkins
United States Senate
Washington, D.C. 20510

Dear Paula:

Having been previously toasted lightly on the legislative fires of immigration reform, nuclear regulation and chairing of the Veterans' Affairs Committee, I don't know why I should choose to tie myself to the stake for one last fry -- but hear me out on this one.

Next week several of your constituents (and mine!) will be in Washington, D.C. urging the very prompt and immediate passage of S. 1300, a bill which purports to assure the "self-sufficiency" of the Rural Electrification and Telephone Revolving Fund (RETRF). As that crew rides in from the west -- and indeed that's from where many will be making the journey -- you will be bombarded with information -- and misinformation -- that the various trade associations have been spreading diligently over the landscape about S. 1300 and its "enemies" who would destroy it.

I come from a state that has been magnificently served by the REA over the years. One of the first national directors of that organization was one J. C. "Kid" Nichols, a Wyoming businessman, who was a dear and lifelong friend of mine. When this remarkable agency first embarked upon its mission in this country it was a stunning thing to observe. It literally changed the face of America. But after the extraordinary effort had been largely completed -- when over 99 percent of rural America then received electrical energy -- then some very creative financiers, accountants, lawyers and businessmen entered the fray. The complexity of the financing schemes and revolving fund capers of the REA would make an atomic scientist blanch. For they will have your eyes whirling like slot machine wheels as they patiently describe the remarkable and complex financing procedures of REA. Why shouldn't it be good -- for few can really understand it. CBOs (Certificates of Beneficial Owernship), borrowings, low-percent interest loans, financing commitments, off-budget borrowing and an extraordinary array of the most electrifying fiscal and credit crunching ways to electrify rural America. However, what will really electrify you is the real cost. I think you need to know that this "self-suficiency" bill really does not compare in any way to what your constituents may have been informed. Bear with me for a moment. Let me relate some of the tales of woe that have been used to increase your fervor and your favor. Let's review the bidding. Here is the pitch presented by the trade associations who really have juiced up the citizens in America (if you will pardon that allusion!). Let's sort them out as "the pitch" and "the fact".

1. The Pitch: "Immediate action is needed right now to avert Rural Electrification and Telephone Revolving Fund bankruptcy."

   The Fact: Indeed RETRF operations must be altered in order to assure the fund's long term solvency -- but remember, we were always told that the ever generous "revolving fund" would "take care of everything" and that "everything" was in good order.

We surely didn't get to this point of distress overnight and there is absolutely no cogent reason to be rammed into action at this particular moment of the legislative year. Congress has already been mighty generous by delaying the RETRF deterioration for yet another year by appropriating $197.8 million to the fund in 1984. Those who are zealously fanning the flames and telling us to "act immediately" don't really want you to slow up long enough to consider any other solutions, or to really understand what S. 1300 is going to cost this country.

2. The Pitch: "This legislation was prepared by a 'blue-ribbon' committee including past REA administrators and the 'best minds' in the industry."

   The Fact: This bill was not drafted by objective parties. It was certainly prepared by the craftiest and wiliest minds in or out of the industry, but it is proposed to really serve the special interest groups that will benefit most from it. Furthermore, while the "blue ribbon" committee may have agreed on the concept of it -- the specific language of the bill was drafted by trade association technicians who see the present financing system in total disarray. Ah, and they always said it "wouldn't cost a nickel!"

3. The Pitch: "The $7.9 billion 'equity transfer' is not a 'forgiveness', and it really won't cost the Treasury or the taxpayer a cent."

   The Fact: Try not to chuckle at that one. Even the Congressional Budget Office calls it a "forgiveness". So do the Congressional Research Service, the Government Accounting Office, the Office of Management and Budget, the U.S. Department of Agriculture and the Treasury. And each and every one of them also say that this "forgiveness" will cost the taxpayers literally billions of dollars. You might wish to ask your banker for this kind of an "equity transfer" on your home mortgage.

4. The Pitch: "The bill shows the borrowers' 'willingness' to pay a higher RETRF rate."

   The Fact: Such "willingness" to pay higher RETRF rates is commendable. The real fact is that the technicians who sliced this rate-setting formula together would have pleased Rube Goldberg, for the rates under this bill will be too low to prevent the RETRF insolvency. Thus the bill really perverts the honest willingness of reliable borrowers to pay rates that are actually high enough to preserve the RETRF.

5. The Pitch: "Technical problems with the rate-setting formula have now been 'corrected' or 'fixed' in the amended House version".

   The Fact: Borrowers have no idea whatsoever what is in store for them under the amended rate-setting formula. Extensive computer modeling of the House formula amendment shows that rates will be erratic, unpredictable, and quite subject to manipulation. The amended formula might have the possibility to work in theory, but it is most unlikely to work in actual practice. But the trade associations won't be too concerned about that because if it fails they'll simply bash our doors down again at some future time for some additional subsidies.

6. The Pitch: "This bill does not 'forgive' any borrower's current debt."

   The Fact: That is right down the pike -- an absolutely true statement and one that has never really been at issue. But the trade associations have used this plump "straw man" to divert our attention from just how this legislation reduces interest rates on future loans by only about 2 percent -- compared with the rates which would be required without all of this new spirit of "forgiveness" and subsidy. Hear that one again please. All of these "forgivenesses" only reduce RETRF rates by 2 percent or less.

The Pitch: "Refinancing of the loan guarantees and REA borrowings from the Treasury is very 'fair' and 'won't cost the Treasury a penny.'"

The Fact: How a "downward-only", penalty-free refinancing can be called "fair" is beyond my pale of comprehension. We do have a word for that out in Wyoming. A really "fair" proposal would have interest rates floating down and up with the government's cost of borrowing. The potential cost of this "one way" refinancing is staggering -- easily in the billions of dollars. But the supporters of the measure say that these refinancings won't cost anything because Treasury won't permit them. Well if they won't be used, why not let's toss them out now?

8. The Pitch: "Even if this bill does 'cost a little', it's 'fair' (again that word) since cooperatives only get a fraction of the subsidies provided to other utilities."

The Fact: Here is an absolute flight from truth. Comparative subsidies have been studied by many organizations including the GAO and CRS. Only the trade associations continue to suggest that co-op subsidies are somehow less than those to the investor owned utilities -- by use of a dazzlingly complex and analytical procedure. The trade associations would hope that certainly if they are to repeat this fiction enough, it will be accepted because it "sounds familiar."

And now the real capper:

The Pitch: "People who oppose this bill or would want to change it in any way are trying to 'turn off the lights' in rural America."

The Fact: This is the one that gets me. In a recent report by the Inspector General of the U.S.D.A. it was found that there were 54 co-ops which had 50 percent or more of their consumers living in Standard Metropolitan Statistical Areas. They are telling you or me that we dare not oppose any part of this legislation or question it or try to improve it because we will then be branded as an "enemy" of rural America -- and that the ranchers and farmers will be there to meet us with a phalanx of pitchforks and shovels when we get back to the old home ground. Certainly there may still be rural citizens in the United States of America who require the extraordinary boons and benefits of electrical power -- if so, then let us serve those people. Let us create those long lines of power that serve only very few people and let us fully subsidize those and get that power out there to those less fortunate persons. But those persons are now very few and the cost of serving all of those people is really peanuts compared to this legislative package we are asked to swallow. I do only urge that the trade associations will spare me the imagery of the leather-faced lady in the tattered calico dress -- with tangled and matted hair like Marjorie Main -- mashing away on a wooden washboard using grandma's lye soap while the nearest light bulb glimmers some 50 miles away over the mountain. I will honestly want to take care of each and every one of those persons that the trade associations can produce, and will use taxpayer's money to do it. That I commit to -- but I really balk when I see REA's peddling power to substantial corporations. One co-op in my own home state had 1982 power sales of 386,000 megawatt hours -- and 354,000 of those hours (91.7%!) were sold to large industrial and commercial users and yet that co-op still qualifies for 2% REA loans That is not right or "fair" (an often used term in this debate and those usable by both sides!). It is a very real example of awesome and even arrogant special interest steam rolling -- for now we are being "advised" that we have to think and vote the way the paymasters of an extraordinarily generous P.A.C. fund will tell us. And please know that I am the beneficiary of some of those P.A.C. funds -- and I have also picked up an honorarium or two. But as thoughtful legislators -- Democrats and Republicans alike -- we should all be offended at the assertion that by our actions in questioning this bill, it is akin to ripping the old wires and insulators out of the chickenhouse.

I guess I must be a perverse rascal. I oppose this bill precisely because of what I am being told -- that I dare not oppose it -- that it would indeed be "political suicide" to get involved. And this is an election year for me! But I have been fed a long string of misrepresentations on this baby -- about what this bill really does and how much it will really cost the taxpayers. Annie Landers had it right when she said, "Wake up and smell the coffee."

I know personally those fine gentlemen and gentlewomen who serve on the various boards of directors of REAs in my own State of Wyoming and there are a remarkable and dedicated lot of them. I also feel that many of them honestly don't have any concept of what this extraordinary "bailout" bill really is. For those persons are the "salt of the earth" types -- the farmer, the rancher, or the small businessman, the guy that really makes America hum -- and these are the same people that write us those wrenching, serious and searching letters saying, "Al, what are you going to do about that $200 billion deficit?" They just have to be searching their souls when they come out to Washington next week to visit with us on this measure.

I deeply believe that the trade associations have consciously or unconsciously misled the public about what this bill really does. And maybe they have been doing that for years. I would not like to think so. Ask your constituents when they hit town if they have been told that the Congressional Budget Office has found that this bill will cost their government over $10 billion bucks by the year 2010.

One of the reasons why we are up to our fannies in deficits (and for me that is a long way off the ground!) is because past Congresses have made some dazzling previous political decisions for us -- "built in" this and "built in" that -- like this commitment of 1984 dollars in legislation crafted many years ago. Take a look at those CBOs (Certificates of Beneficial Ownership) and where we go from here on them. In the year 2006 a first balloon payment of $353.6 million will become due. But nowhere in the proposed legislation is there any money provided for repayment of that principal amount. In fact, the House formula amendment specifically states that interest expense is to meet interest income -- but how about the principal? When that first CBO comes due I hunch we will be asked for another simple conversion of "debt" into "equity". The total CBO amount now outstanding is approximately $3.5 billion. We all ceremoniously wring our hands (and I do too, and I don't leave myself out) about the deficit and try and search, and grapple to figure out honestly how to make a "down payment" on it. And yet the trade associations that press for S. 1300 would have us decide in this year of 1984 to give away billions of 1985 - 2016 tax dollars to bail out an industry that doesn't even need to be bailed out. I have only labored in this vineyard for a bit over five years, but I have never seen one quite like this. This bill is a classic case study of how special interest groups -- using a magnificent blend of emotion, hype, high drama, guilt, political retribution and wretched distortion -- all with a rich background of violin music from "the days of yore" in an attempt to unload today's problems on tomorrow's taxpayers by mobilizing and manipulating some very fine citizen constituents. We still have a crack at changing the ending of this story and we might just make it a case study of how an informed and alert Congress decided to educate itself and refused to blindly and blandly just add billions of dollars to the indebtedness of future generations of rural Americans and all other taxpayers.

I am looking at some alternatives. I would hope that you might resist the pressure to "sign on" to S. 1300 or maybe even withdraw your present support of it. I would urge you to counsel with your good constituents and inform them on some of the facts that the trade associations have withheld from them. I will be furnishing the stack to you. Finally, I would sincerely urge you to work with me to develop a reasonable, honest and fair alternative to S. 1300 that will keep those rural lights burning without searing the taxpayers' pockets for a long time to come.

I would hope you might lay back on this one and take a very close look at it. If you mull around in it long enough you might see how an extremely sophisticated special interest lobby has taken a most magnificent program and through use of a remarkable array of scalpels, wrenches and sledge hammers has fashioned a bizarre blend of on-budget/off-budget financing and subsidy packages through use of the Federal Financing Bank and other methods over these many years that would greatly and deeply disappoint, sadden and distress the creators of rural electrification in this country. This session would be a good time to address the issue as to where it all went awry. Just be assured that it did. So I am ready to dig in for the long haul on this one. I get lots of dazzling flack from the trade associations -- but no answers. Will you join me in seeking and getting some?

I thank you for your attentiveness.

With best personal regards to you.

Sincerely,

Alan K. Simpson
United States Senator

AKS/tb

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

JAN 17 1984

Honorable Paula Hawkins
United States Senate
Washington, D. C. 20510

Dear Paula:

Thank you for your letter requesting my comments on S. 1300.

The Administration is strongly opposed to S. 1300 because it provides a substantial increase in subsidies to the already heavily subsidized electric and telephone cooperatives.

Federal taxpayer dollars going to rural electric cooperatives over the last ten years have resulted in estimated (on and off budget) spending of $31.8 billion. The economic value of the subsidies and benefits is estimated at over $38 billion.

Two independent studies, by the Congressional Research Service and by National Economic Research Associates, Inc., support the conclusion that total Federal subsidies to REA borrowers are greater than any Federal subsidies provided to private utilities on a per customer basis. The 1982 NERA study conservatively estimates that for a new utility investment made in 1981, taking into account tax changes under ERTA and TEFRA, the annual subsidy per customer is more than three times greater for coops than for private utilities.

In addition to the above benefits, REA administrative costs to assist these borrowers totaled about $200 million over the last decade; nearly all cooperatives' revenues were exempt from Federal income taxes; and cooperatives had preferential access over private utilities to low cost Federal power.

Not surprisingly, electric rates charged by REA borrowers on average are lower than the rates charged by other electric utilities.

- Nationwide, REA borrower electric rates are about 12% lower than rates charged by other utilities.
- Even on an individual neighbor-to-neighbor comparison, rates charged by REA electric borrowers to residential customers are significantly lower than rates charged by neighboring non-REA utilities in 80% of the States with REA assistance.

In an independent report to Congress, the U.S. Comptroller General (GAO) concluded that residential customers served by REA borrowers pay less for the same amount of electricity used by residential customers of private utilities. The 8.5 million residential customers served by cooperatives receive lower cost power on average than the 63.8 million residential customers served by investor owned utilities.

The original purpose of the agency and 1936 Act was to bring electric and telephone service to farms and rural areas. About 99% of farms and rural areas are electrified and about 95% have telephone service.

Furthermore, telephone program borrowers have already received substantial tax benefits under the reforms enacted in 1981 (ERTA) and 1982 (TEFRA) and the existing REA subsidy programs including 5% direct insured loans, subsidized RTB loans, and the FFB direct loans (loan guarantees). Many of the telephone companies either have the capability or already borrow in private credit markets. In view of the preceeding, increases in Federal subsidies as contained in the bill are not justified and would only increase reliance on Treasury lending.

S. 1300 would increase the Federal deficit by at least $19 billion over the next several years by:

- forgiveness of $7.9 billion in loan principal due Treasury beginning in 1993.
- refinancing of CBO's (borrowings from the Treasury) to lower interest rates when old CBO rates are at least one percent above current rates.
- refinancing of loan guarantees every seven years when the Treasury lending interest rate exceeds the current Treasury rate by at least one percent and when the borrower requests it.
- requiring third party debt guarantees by REA Administrator. This could insure all cooperative borrowing is federally subsidized.
- requiring subordination of Government first lien status--risking billions in Government assets.
- including broader criteria for the special (2 percent) interest rate on insured loans.

Instead of accepting S. 1300, I propose that we reduce Federal risk and encourage more private sector involvement by:

- reducing existing Government loan levels over time and requiring coops to increase private borrowing.
- reducing the Federal share in rural electric and telephone funding. A Lehman Brothers' report concludes that the coops can significantly increase private sector borrowings to meet financial needs.
- encouraging, through these actions, major improvements in REA borrower balance sheets so that they could at last operate in a more business-like environment with less, not more, Government dependence.

I have enclosed a detailed package of materials that will be helpful to you and your staff concerning our technical and analytical conclusions, including:

- ° Tab 1: Detail on existing subsidies provided to rural coops
- ° Tab 2: Detail on additional subsidies in S. 1300
- * ° Tab 3: National Economic Research Associates' paper on coop subsidies
- ° Tab 4: Congressional Research Service paper on coop subsidies
- ° Tab 5: Comparison between coop rates and industry rates
- ° Tab 6: GAO study on electric coops
- ° Tab 7: North Anna REA purchase press release
- ° Tab 8: Lehman Brothers report on Financial Needs (Table of Contents and Findings only)

As Secretary Block noted in his October 28, 1983, letter to Representative de la Garza, Chairman of the House Agriculture Committee, the Administration believes that a strong, healthy rural electrification program remains important to ensuring the economic health and quality of life of rural areas. But S. 1300 represents a grossly inequitable effort to use taxpayer dollars to provide special benefits to private business interests that have organized a massive pressure campaign. Were it to pass in its current form, I would not hesitate to recommend that the President withhold his approval of the bill.

The Administration looks forward to working with the Congress to deal effectively with the revolving fund problem over the next few years.

Sincerely,

David A. Stockman
Director

Enclosures

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* Not printed in this publication.

TAB 1

SUBSIDIES AND BENEFITS TO RURAL ELECTRIC COOPERATIVES

1. Access to funding. Many borrowers would have been unable to obtain non-Federal funding support at any price. The Act provided a vehicle for such funding support.

2. Free technical, engineering, and management support services. REA employees continue to provide free engineering support, management assistance, and financial oversight/guidance to REA borrowers, activities which would be of considerable value if paid for in the open market. REA engineering research and development activities actually made rural electrification and telephone service economically feasible.

3. Access to funding at rates substantially below "normal" market rates. REA loans at 2% and 5% carried substantial subsidy value vis-a-vis both the cost of borrowing to government and private market rates. The degree of value has obviously varied according to the spread between the REA rate and the other prevailing rates.

4. "Free" capitalization of the RETRF. The RETRF has been provided use of nearly $8 billion in loan assets interest-free. This capitalization has permitted larger loan programs than would otherwise would have been possible, and conservatively costs the government over $300 million in interest revenues foregone each year.

5. Access to guaranteed loan financing. As with distribution loans, many guaranteed loan borrowers would have been unable to obtain the financing at any cost, much less at the preferred rate offered by FFB.

6. Tax exempt status.

7. Eligibility to participate in various leveraged leasing and/or Safe Harbor arrangements. Such financing options have provided REA borrowers with over $1.5 billion in benefits.

8. Capped supplemental financing ratio ("70/30").

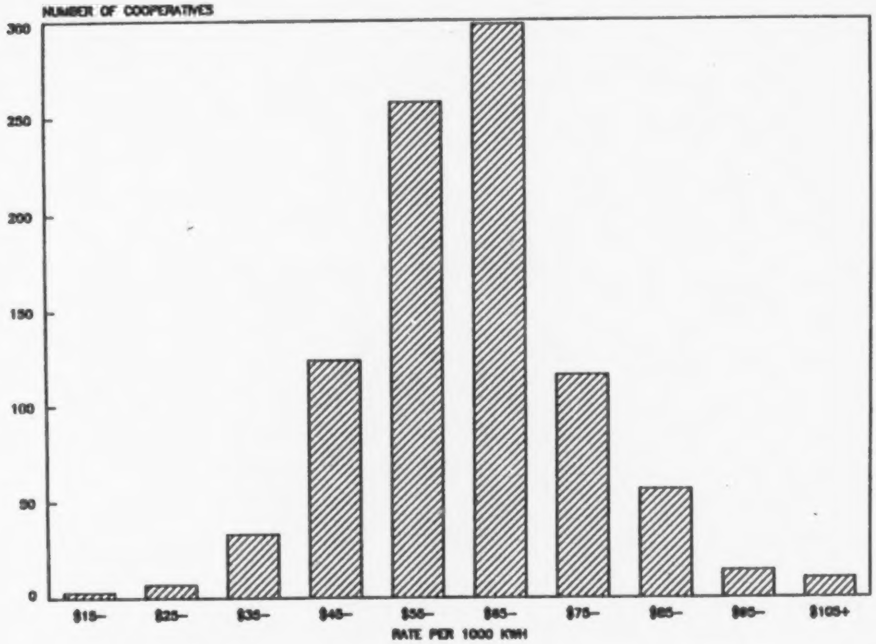
9. Appropriated costs of administering full range of REA programs and support activities. Current year administrative costs at nearly $29 million.

10. 1984 appropriation to cover "interest losses." Congress provided the RETRF with an infusion of $197.8 million via direct appropriation.

11. Low cost Federal capitalization of the Rural Telephone Bank.

12. Access to low cost financing through RTB and CFC (with others) at rates which would not be as competitive were it not for the Federal presence.

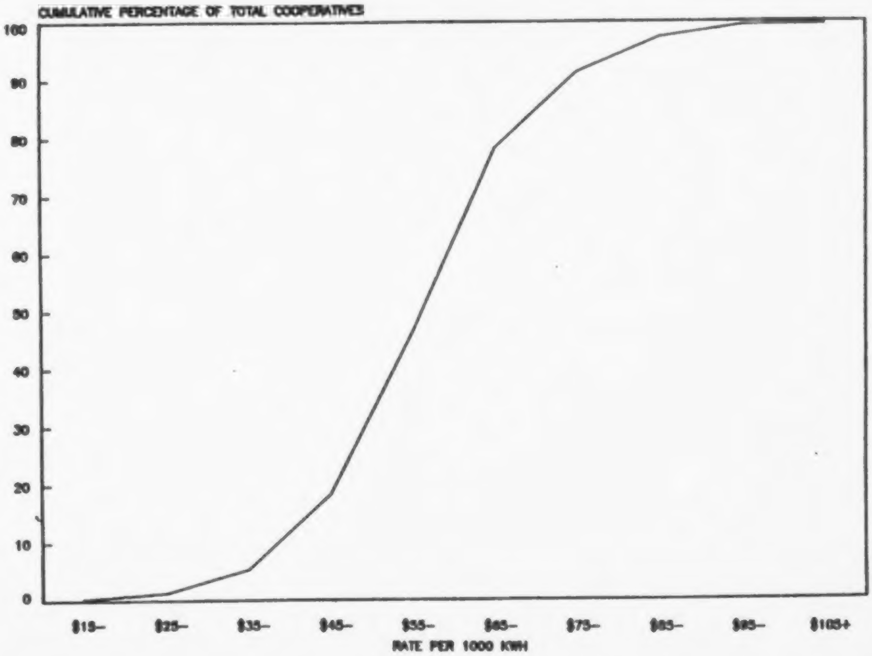
FREQUENCY DISTRIBUTION OF RATES PAID BY RURAL ELECTRIC COOPERATIVE CONSUMERS FOR 1000 KILOWATT HOURS OF ELECTRIC SERVICE IN 1983



Source: Compiled by CRS from data supplied by the Rural Electrification Administration of the U.S. Department of Agriculture.

Note: According to the U.S. Energy Information Administration, the typical bill for 1000 kwh paid by customers of private and municipal electric companies was $69.96 in 1983.

CUMULATIVE FREQUENCY DISTRIBUTION OF RATES PAID BY RURAL ELECTRIC COOPERATIVE CONSUMERS FOR 1000 KILOWATT HOURS OF ELECTRIC SERVICE IN 1983



FEDERAL TAXPAYER DOLLARS GOING TO RURAL UTILITIES OVER THE LAST TEN YEARS ADD UP TO MASSIVE SUBSIDIES AS SUMMARIZED BELOW:

I. Direct Federal Budget/Taxpayer Costs:

	$ Billion
- Interest subsidies on 2% and 5% direct loans (life of loans)	12.3
- Interest subsidies on $7.9B interest-free capital from Treasury (life of investment).	17.5
- Tax receipts foregone resulting from coop use of Safe Harbor Leases	1.4
- Tax revenues foregone from electric coop use of pollution control tax exempt municipal bonds	.6
TOTAL	31.8

II. Economic/Society Costs:

- Interest subsidies on Federal loans (life of loan)	
direct	21.5
guaranteed	15.1
- Safe Harbor Leasing cash payments	.9
- Tax exempt pollution bonds	.6
TOTAL	38.1

TAB 2

ADDITIONAL SUBSIDY DIRECT BUDGET COST ABOVE THE PRESIDENT'S BUDGET AS A RESULT OF H.R. 3050

	$ Billions
Cost of forgiveness of Treasury capital........	7.9
Cost of CBO interest subsidies due to refinancing CBO's over the 1984-90 period......	6.4
Cost of interest rate reductions through refinancing for guaranteed loans (life of the loan) for loans refinanced during the 1984-90 period..	4.7
Cost of mandatory third party debt guarantees..	1/
Cost of mandatory subordination of REA first lien loans outstanding........................	1/
TOTAL............................	19.0

1/ The cost of these subsidies are too uncertain to estimate but could be in the billions if borrowers ever defaulted or delayed interest or principal repayment. The market value of either subsidy would be substantial (billions) if used.

TAB 4

INVESTOR-OWNED ELECTRIC UTILITIES VERSUS RURAL ELECTRIC COOPERATIVES: A COMPARISON OF TAX AND FINANCIAL SUBSIDIES*

I. INTRODUCTION AND SUMMARY

Electrical power in the United States is supplied by a wide array of business entities, ranging from gigantic privately-owned corporations to utilities owned by the municipalities they serve to tiny rural cooperatives. Regardless of size or form, they share several important distinguishing features: they enjoy government-granted monopolies in their marketing areas, they operate on a "cost plus" basis due to rate regulation or their form of organization (e.g. cooperatives), and they enjoy sizeable subsidies from the Federal government. These subsidies take different forms for the different types of electric utilities. Investor-owned utilities (IOUs) receive sizeable tax benefits, primarily in the form of accelerated depreciation and the investment tax credit, which offset part or all of the income tax imposed on profit-making private corporations. Rural electric cooperatives (RECs) are tax exempt and, in addition, receive low-interest or guaranteed loans under the auspices of the Rural Electrification Administration (REA). Municipal utilities are also tax exempt and, in addition, are able to sell bonds on which the interest is tax exempt to the purchaser.

A normal presumption would be that the subsidies provided to the rural co-ops and the municipally-owned utilities substantially exceed the subsidies received by IOUs. However, this presumption has recently been questioned especially in light of the increase in tax benefits provided to IOUs by the Economic Recovery Tax Act of 1981 (ERTA). Specifically, a document published by the National Rural Electric Cooperative Association (NRECA) alleges that:

> "Contrary to general impressions, however, it is not rural electrification or electric cooperatives to which the major Federal help goes. The greatest amount of Federal assistance has historically gone to the investor-owned utilities, and their share is being substantially increased under the 1981 Tax Act." 1/

The NRECA paper reports estimates of Federal financial assistance per consumer in 1981 for the three types of electric utilities; the figures are $9.46 per consumer for rural electric cooperatives, $40.45 for municipal utilities,

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1/ National Rural Electric Cooperative Association, Let's Talk Facts About Subsidies to Utilities (pamphlet).

* Donald W. Kiefer, specialist in public finance and financial institutions, Economics Division, Congressional Research Service, the Library of Congress.

and $42.48 for investor-owned electrics. These estimates were challenged in a paper by Joe Pace presented at a conference sponsored by the NRECA. 2/ Pace estimated the subsidy per consumer as $40.29 for RECs versus $7.24 for IOUs (he did not compute estimates for municipals).

The following study likewise compares the Federal financial subsidies received by investor-owned electric utilities and rural electric cooperatives. However, the methodology differs from that described above. Rather than calculate a dollar amount of subsidy per customer, this study estimates the reduction in utility rates charged to customers as a result of the Federal subsidies. Since it is the price response which determines the economic effects of the subsidies, this would seem to be a more appropriate way to measure and compare the subsidies.

The scope of the analysis is limited to the effects of the investment tax credit and accelerated depreciation on IOUs and the effects of tax exemption and REA lending subsidies on RECs. Other benefits or detriments which result from government policies--such as marketing monopolies, rate of return regulation, or the ability of RECs to purchase Federal power on a preferential basis--are not included. Since all of the subsidies considered in the analysis affect capital costs rather than operating expenses, the estimates focus exclusively on capital costs as reflected in utility rates. Capital costs amount to slightly more than 25 percent of the cost of electricity purchased from both IOUs and RECs, a fact which should be borne in mind in interpreting the results.

Assessing the effects of the financial subsidies on utility rates requires an understanding of the utility ratemaking process and some aspects of the financial operations of the utilities. These subjects are discussed in sections II and III of the paper for IOUs and RECs respectively. Because the relationships involved are complex, the discussion is occassionally technical, and equations are used to express the essential relationships. Readers who wish to obtain only a general sense of the results may wish to skip some sections of the more technical discussion, particularly pages 12-16. This material has not been placed in an appendix, however, because it is essential for the reader who wishes to understand fully the meaning of the estimates in the remainder of the report.

Most of the complexity in utility regulation discussed in this report involves the ratemaking treatment of the tax benefits received by the investor-owned uti-

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2/ Pace, Joe D., The Subsidy (or Lack Thereof) Received by Cooperative Electric Utilities, presented at the National Rural Electric Cooperative Association 1982 National Tax Conference, Minneapolis, May 25-27, 1982. The paper is summarized in Cavanaugh, H.A., Who Gets More Aid - Privates or Co-ops?, Electrical World, August 1982, pp. 37-41.

lities. The tax benefits received by IOUs are "normalized" in determining utility rates to be charged to customers. This means essentially that the benefits are used to reduce utility rates over the lives of the utility's assets rather than only in the year of receipt of the actual benefits. For example, utility rates are not reduced to reflect the full amount of the investment tax credit in the year the credit is received; instead rates are reduced by a proportionate amount each year over the life of the asset for which the credit was received. However, the normalization rules, which are specified in the tax code, do not permit the full benefit of the investment credit to be reflected in lower utility rates even over the entire life of the asset (this is not true for accelerated depreciation). Some of the investment credit benefit increases the rate of return received by the IOU's shareholders (unless this effect is offset by the ratemaking decisions of the regulatory agency).

Since the purpose of this analysis is to compare the magnitudes of the financial subsidies received by the utilities, the estimates for the IOUs are calculated on two bases: first, assuming the tax code normalization rules, and second, assuming a normalization procedure which would fully reflect the tax benefits in lower utility rates over the lives of the assets while leaving the rate of return received by utility investors constant. The estimates for the RECs are also calculated on two bases: first, taking into account only the effects of tax exemption, and second, taking into account the effects of both tax exemption and the REA loan subsidies.

Estimates of the effects of the Federal financial subsidies on capital costs in utility rates for IOUs and RECs are presented in section IV. The estimates are calculated using three different approaches. First, the estimates are based on average financial data, including average capital cost data, for the utilities in 1980. These estimates indicate the effects on utility rates charged to customers in that year. The results (presented in Table 3) imply that the tax benefits received by IOUs reduced capital costs in utility rates by 7 percent, and would have reduced rates by 11 percent if the tax benefits would have been fully reflected in reduced utility rates. Tax exemption reduced capital costs in utility rates for RECs by an average of 26 percent in 1980, and the combination of tax exemption and REA loan subsidies reduced REC rates by 40 percent (this is a conservative estimate because the effects of the loan subsidies are probably underestimated).

The second estimation procedure is to use capital costs associated with new financings by the utilities in 1981. This approach assesses the effects of the financial subsidies if the high 1981 financing costs were to remain permanent; since financing costs have recently dropped substantially the estimates serve primarily to illustrate the effects of the subsidies assuming upper-limit financing costs. The estimates (presented in Table 4) show that the percentage reduction in capital costs in utility rates resulting from the financial subsidies is not highly sensitive to the capital costs. The utility rate reductions for the IOUs remain 7 percent and 11 percent, respectively. The rate reductions for the RECs decrease somewhat. The reduction of capital costs in utility rates due to tax exemption decreases to 22 percent and the reduction due to both tax exemption and loan subsidies decreases to 35 percent.

The third estimation procedure is to calculate the capital costs in utility rates each year over the life of a hypothetical new utility investment. This type of simulation estimation is necessary to capture the effects of current tax policy and financial costs since the historical financial data of the utilities reflect past tax policy (prior to the revisions in the Economic Recovery Tax Act of 1981 and the subsequent changes in the Tax Equity and Fiscal Responsibility Act of 1982) and average historical capital costs. The simulation results have some interesting implications. For example, the results reveal that it is possible for a taxable firm to have lower capital costs in utility rates than a tax-exempt firm during some years of the asset's life despite the fact that the taxable firm must earn the pretax rate of return on equity and pay income taxes on its equity income each year. This is because the taxable firm has a third component in its capitalization structure in addition to debt and equity: zero-cost capital in the form of tax deferrals. If this form of cost-free capital becomes large enough, its effect in reducing capital costs outweighs the effect of having to earn the pretax return on equity in increasing capital costs. Deferred taxes grow large enough to have this effect during the later years of the asset's life.

The simulation results indicate that the capital costs in utility rates are lower for a REC during the early years of the asset's life, and lower for an IOU during the later years. This means that the question of which type of utility receives the largest subsidy can be answered only by calculating discounted present values of the utility rates. This procedure, of course, raises the question of what is the appropriate discount rate. Rather than select a single rate, calculations were made using rates ranging from 5.25 percent to 20 percent. The results of the present value analysis make the subsidy to the IOUs appear larger, and the subsidy to the RECs appear somewhat smaller, than the earlier estimates.[4] But, with one exception, relationships within the results are generally consistent with the earlier estimates. The exception is that whether an IOU with constant-rate-of-return normalization or an REC considering only the effects of tax exemption receives the larger subsidy depends on the discount rate assumed (at a low discount rate the IOU receives the larger subsidy). The results indicate that capital costs in utility rates are reduced by the Federal financial subsidies by 8 to 14 percent in a tax-code normalization IOU and by 18 to 25 percent in a constant-rate-of-return normalization IOU. For the RECs the decrease is 20 to 21 percent if only the effects of tax exemption are considered and 32 to 34 percent if both the effects of tax exemption and the REA loan subsidies are taken into account.

The results of this analysis support the conclusion that rural electric cooperatives currently receive larger subsidies from the Federal Government through tax-exempt status and borrowing subsidies than investor-owned electric utilities receive through the investment tax credit and accelerated depreciation.[5] However, if the analysis focused only on tax subsidies, or, alternatively, if the lending subsidies to the RECs provided through the Rural Electrification Administration were eliminated, then the conclusion would not be so clear. In this case, who receives the greater subsidy depends on the discount rate used in the present value analysis. A low discount rate would lead to the conclusion that IOUs receive the greater tax subsidy; a high discount rate would lead to the opposite conclusion.

TAB 5

REA ELECTRIC BORROWER RATES ARE LOWEST AMONG ALL ELECTRIC RATES

On average, residential customers of REA electric borrower utilities enjoy cheaper electric service than residential customers of non-REA electric utilities.

* In about 80 percent of the states with REA borrowers the rates charged by REA electric borowers were significantly lower than the rates charged by neighboring non-REA electric utilities.

REA electric rates are about 12 percent lower than non-REA rates on a nationwide basis. This difference may be due to a number of factors, including Government subsidies to REA borrowers and lower costs in rural areas. Whatever the cause, this difference (the substantial amount REA borrower rates are lower than non-REA rates) would argue against the continuation of massive Federal Government subsidies to rural electrification.

Rural electric interests have argued against the nationwide comparison with the claim that the rates of neighboring utilities should be compared, and on a state by state basis. The current analysis, the conclusion from which is cited at the top of this page, follows the methodological wishes of the rural electric interests. Monthly residential electric bills for each REA borrower were compared to the bills of that borrower's closest non-REA electric utility. State averages were then determined and the following observations were made:

Monthly Consumption (kWh):	250	500	750	1000	2500
States with non-REA rates higher (on average)	27	31	36	37	36
Percent	57%	65%	78%	80%	78%
States with REA rates higher on average	19	15	10	9	10
Percent	43%	35%	22%	20%	22%
Total States analyzed	46	46	46	46	46

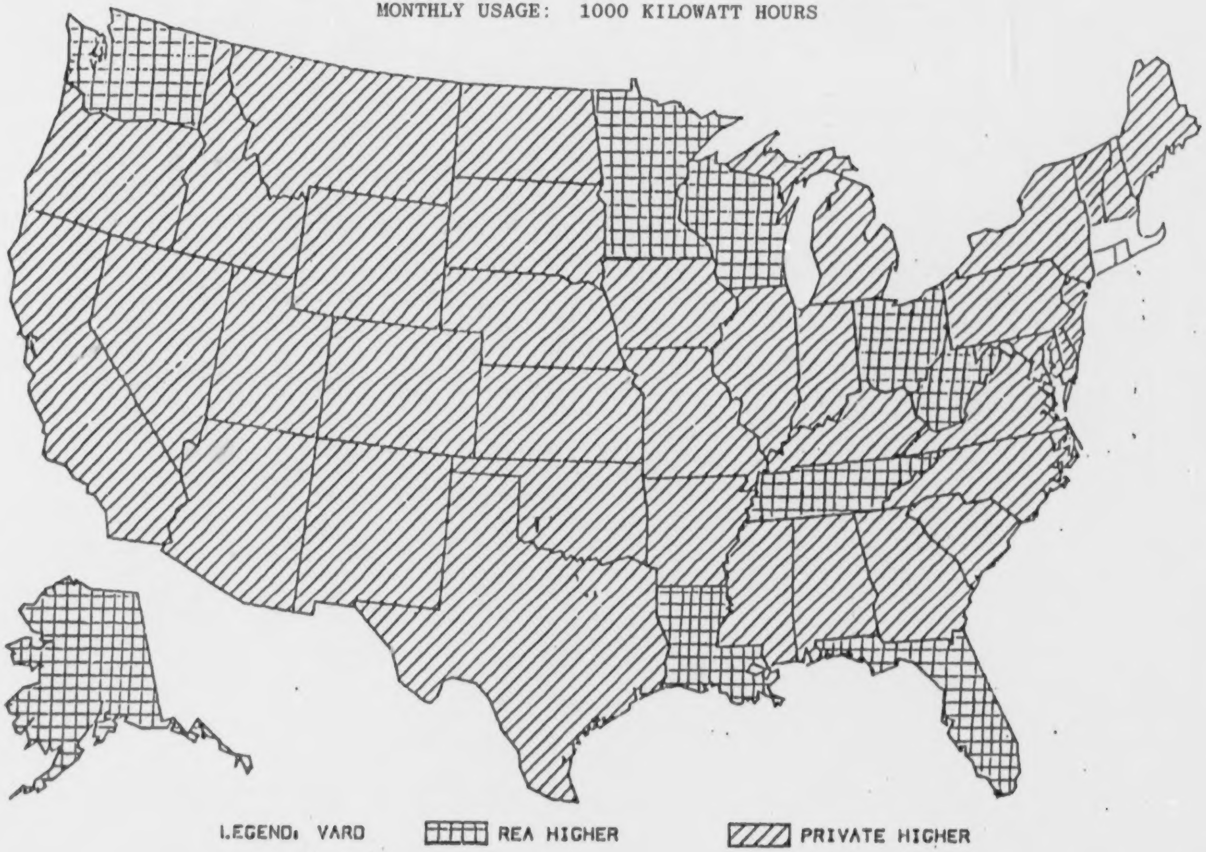
Only 46 states were used in this analysis. The other four states -- Connecticut, Hawaii, Massachusetts, and Rhode Island -- have been exluded because they have no REA borrowers. Typical monthly electric bills are usually for 900 kilowatt hours. Therefore, the 1000 kWh category is used here as a surrogate for the typical electric bill.

The REA rates have been adjusted to account for patronage capital rebates provided to residential customers of REA borrower utilities. The patronage capital rebates were discounted over 10-30 years depending on each utility's policy. Those utilities providing no rebates received no rate adjustment.

Attached is a map showing for 1000 kWh the states with REA borrower electric rates higher and lower.

TYPICAL ELECTRIC BILLS IN 1981: REA BORROWER VERSUS NEAREST NON-REA (LABELED "PRIVATE") UTILITY, BY STATE

MONTHLY USAGE: 1000 KILOWATT HOURS


LEGEND: VARD
▦ REA HIGHER
▨ PRIVATE HIGHER

TAB 6

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-207753

To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the growth and changes that have occurred in some tax-exempt electric cooperatives since they were first granted tax exemption in 1924. It also discusses the difficulty the Internal Revenue Service (IRS) has had in attempting to apply the broad tax exemption provisions of the Internal Revenue Code to differing present day cooperatives.

We made this review as part of our efforts to assess the adequacy and administrability of various tax exemption provisions in today's environment. Electric cooperatives are a major type of nonprofit business organization exempt under Section 501(c)(12) of the Internal Revenue Code.

Copies of the report are being sent to the Director, Office of Management and Budget; the Secretaries of Agriculture, Energy, and the Treasury; the Commissioner of Internal Revenue; and other interested parties.

Charles A. Bowsher
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

LEGISLATION NEEDED TO IMPROVE ADMINISTRATION OF TAX EXEMPTION PROVISIONS FOR ELECTRIC COOPERATIVES

DIGEST

Because electric cooperatives are exempt from Federal income taxes, GAO wanted to know whether the laws are adequate and whether they are being effectively administered by IRS. GAO found that since electric cooperatives were granted exemption almost 60 years ago, the operations of many cooperatives and the environment in which they do business have changed substantially.

In administering tax exemption, IRS has tried to recognize the changes in electric cooperatives. However, it has had difficulty doing so because of the broad nature of the statute. The law generally exempts all electric cooperatives regardless of differences in their operations and activities, financial condition, size, or mix of consumers served.

IRS needs to make administrative changes to better enforce existing tax exemption provisions. More importantly, the Congress, using alternatives suggested by GAO as a guide, should establish a tax treatment which better recognizes the changing operations and present day environment of many electric cooperatives and their continuing need for assistance.

MANY ELECTRIC COOPERATIVES HAVE CHANGED SUBSTANTIALLY

Originally, most electric cooperatives were small associations which distributed electricity to sparsely populated rural areas. These cooperatives were made exempt from Federal income taxes under section 501(c)(12) of the Internal Revenue Code, which provides exempt status to mutual or cooperative companies deriving their income principally from members.

Today, many electric cooperatives serve both rural and suburban areas and closely resemble investor-owned utility companies in their operations and activities. In 1935, only about 30 electric distribution cooperatives existed, the largest of which had 63 miles of line and just 350 members. As of 1981, 920 electric distribution and power supply cooperatives were in operation with an average of 2,020 miles of line and about 10,400 consumers. Moreover, electric cooperatives' total operating revenues grew from $230 million in 1950 to about $7.4 billion in 1981.

Some electric cooperatives have expanded their activities by forming subsidiaries and associations of cooperatives which generate power, provide financing, own and lease coal mining properties and facilities, procure fuel and supplies, and provide ancillary business services. Others have expanded through the acquisition of small investor-owned utilities and interests in jointly-owned power generation plants. (See pp. 9 to 21.)

Another indication of electric cooperative growth is that many cooperatives have been able to accumulate and retain substantial amounts of member equity or patronage capital--about $3.9 billion as of December 31, 1981. A basic cooperative operating principle is that cooperatives should provide service at cost and distribute any margins or savings to members in proportion to their business or patronage. Under this principle the actual refunding of members' patronage capital is a management decision based on an assessment of cooperative operating needs and planned growth. Some cooperatives are using equity management plans to assist in balancing their financial requirements with their need to return members' patronage capital. Others have no such plans or intentions to establish them. (See pp. 34 to 38.)

IRS HAS PROBLEMS ADMINISTERING TAX EXEMPTION PROVISIONS

In administering tax exemption, IRS has tried to consider the changes in electric cooperatives' operations and the environment in which they do business. It has taken positions on tax exemption issues and has published requirements electric cooperatives must meet to qualify for exempt status. However, IRS has been hampered by the broad legislation which has not changed significantly since the 1920s and, thus, does not reflect differences in many present day cooperatives. (See pp. 42 to 44.)

IRS' compliance program centers on the one specific legislative criteria--the requirement that 85 percent or more of a cooperative's income be collected from members for the sole purpose of meeting losses and expenses. But even this requirement has proven difficult for IRS to administer and for electric cooperatives to comply with. IRS has not provided sufficient guidance for cooperatives to properly compute the member income test. Furthermore, in view of the significant amounts of tax-free nonmember income permitted under law--more than $160 million in 1981--it is questionable whether the 85 percent member income requirement is still the best way to assist small cooperatives. (See pp. 45 to 48.)

To facilitate IRS' administration of tax exemption, GAO recommends that IRS take certain actions, including providing more complete guidance on the computation of the member income test. (See p. 49.)

GAO RECOMMENDS ADOPTION OF A TAX TREATMENT WHICH BETTER RECOGNIZES CHANGES IN SOME ELECTRIC COOPERATIVES

Unlike Federal assistance programs which can be directed to those organizations having a continuing need for assistance, tax exemption applies across-the-board to all electric cooperatives. Thus, despite changes in the operations and activities of some electric cooperatives, all cooperatives continue to benefit from tax exemption provided they meet the broad statutory requirements of section 501(c)(12) of the Internal Revenue Code.

GAO recommends that the Congress establish a tax treatment to better recognize the changes in electric cooperatives' operations and activities. To this end, GAO proposes alternatives to the present law which would (1) modify electric cooperatives' nonmember income allowance, or (2) eliminate that allowance, and/or (3) apply tax rules already applicable to other types of cooperatives. GAO emphasizes that these alternatives, which would have an estimated revenue impact ranging from $2 million to $45 million, *are by no means all inclusive*. Rather, GAO suggests them as a framework for the Congress' consideration. (See pp. 54 to 56.)

AGENCY COMMENTS AND GAO'S EVALUATION

The National Rural Electric Cooperative Association, IRS, and the Departments of Agriculture and the Treasury comments ranged from general agreement on administrative issues by IRS to total disagreement by NRECA. The Edison Electric Institute was also asked to comment but declined the opportunity. (See Apps. V to VIII.)

NRECA disagreed with GAO's conclusions regarding the changes in the circumstances which initially motivated Federal Government involvement in rural electrification and on the extent to which present day cooperative operations and activities have changed. In contrast, IRS stated that electric cooperatives are much different today. GAO reemphasizes that while the special circumstances and operating environment of *some* cooperatives may not have changed, those of *others* have changed substantially. *Yet*, tax exemption continues to apply across-the-board to *all* electric cooperatives and does not recognize differences in their operations. (See pp. 31 to 33.)

Agriculture and NRECA contended that the report does not recognize the need for electric cooperatives to retain member equity and that taxing cooperatives could affect their ability to build up equity levels. GAO recognizes that cooperatives need to retain equity capital to become self-sufficient but emphasizes that in accordance with cooperative operating principles, cooperatives are to return to members amounts accumulated above reasonable business needs. GAO also believes that *cooperatives could find equity management plans useful* for assuring that a proper balance is achieved between building needed equity and returning patronage capital and suggests that REA encourage the use of such plans. (See pp. 40 and 41.)

GAO also points out that under its proposed alternatives, electric cooperatives generally would be taxed only on their nonmember income and that such taxes should have little impact on electric cooperatives' ability to build equity. Moreover, these tax treatments would better recognize the differences in present day electric cooperatives and would be a step towards more equitable taxation of the Nation's electric consumers. (See pp. 59 and 60.)

NRECA also disagreed with GAO's findings and conclusions concerning the problems and difficulties related to IRS' administration of the tax exemption provisions. In contrast, IRS essentially agreed with GAO in this regard. (See pp. 51 to 53.)

Treasury commented that GAO's proposed alternatives should have included the outright repeal of tax exemption. In this regard, Treasury questioned the need for any type of Federal subsidization of cooperatives and stated that GAO's report should have been expanded to cover all types of assistance to electric cooperatives. GAO points out that while the issues raised by Treasury merit consideration, they were not within the scope of GAO's review. (See pp. 8 and 59.)

TAB 7

REA ADMINISTRATOR SIGNS $263 MILLION LOAN GUARANTEE FOR VIRGINIA POWER PROJECT

WASHINGTON, September 30—Harold V. Hunter, administrator of the U.S. Department of Agriculture's Rural Electrification Administration, today signed a loan guarantee commitment of $263 million for Old Dominion Electric Cooperative of Richmond, Va. The loan will be used to buy an 11.6 percent interest in the ownership of North Anna nuclear power station on Lake Anna in western Virginia.

During ceremonies held at USDA headquarters, Hunter said, "I take great pleasure in signing this loan today. It represents a joint effort by Old Dominion and Virginia Electric Power Company to address many of the problems that need to be solved to assure adequate electric service in the future. I commend Old Dominion and VEPCO for their efforts."

The U.S. Treasury's Federal Financing Bank will loan $241.5 million for the project; additional funds may be obtained from the National Rural Utilities Cooperative Finance Corporation.

Old Dominion is an electric power purchasing cooperative with 12 member cooperatives: ten in Virginia and one each in Maryland and Delaware. These 12 cooperatives distribute electric service to nearly 246,000 consumers in Virginia, Maryland, Delaware and West Virginia.

Nine of Old Dominion's members in Virginia will receive power from the North Anna station, which is expected to provide basic load requirements for the cooperatives in the future. Upon completion of the North Anna purchase, existing wholesale power contracts between the nine cooperatives and the Virginia Electric and Power Company will end.

The Rural Electrification Administration makes loans and guarantees loans to finance electric and telephone service in rural areas.

Since 1935, REA has approved or guaranteed $47.8 billion in loans to electric borrowers in rural areas of 46 states, Puerto Rico and the Virgin Islands serving nearly 24 million consumers.

REPORT TO COMMITTEE ON OBJECTIVES AND PLANNING OF NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

(By Lehman Brothers Kuhn Loeb Inc., Nov. 29, 1982)

PART I—FINDINGS AND RANKING OF FINANCING ALTERNATIVES

The Committee on Objectives and Planning ("The Committee") of National Rural Utilities Cooperative Finance Corporation ("CFC") has undertaken a major study of the future capital requirements of the rural electrification program and the possible means by which these requirements can be met, with particular emphasis on financing alternatives to the Rural Electrification Administration's ("REA") present lending programs.

As our contribution to this study, Lehman Brothers Kuhn Loeb Incorporated ("LBKL") has prepared this Report, which analyzes the anticipated financial requirements of the distribution cooperatives and the power supply generation and transmission cooperatives ("G&Ts"), places these requirements in the context of the general money markets and the competitive demands for investment funds, and reaches conclusions as to the relative merits of different private financing alternatives under varying market conditions and levels of government support. The Report also analyzes CFC's role in financing its member systems, recommends certain changes in CFC's structure, and describes a new method for the collective financing of the G&Ts with CFC support which we believe to have substantial merit. In carrying out this assignment, our overriding goal has been to balance the twin objectives of maximizing total capital availability and minimizing financing costs to the ultimate consumer.

This Report has drawn on LBKL's broad expertise as a major investment banking firm and more particularly on our knowledge of the rural electric program gained from our close association with the original Long Range Study Committee and with CFC since its formation.

In judging CFC's capabilities in the years to come, we deal with projections and prognostications. Sharing the human inability to see into the cloudy future, it has been necessary to form certain judgments about trends and markets, as well as levels of government support, interest rate levels, demand for funds and many other factors in order to draw some reasoned conclusions and develop a program for the future. We believe our hypotheses are reasonable, although they are certainly open to disagreement, and that time is likely in its wonted way to develop conditions no one could have foreseen.

Nevertheless, certain conclusions have been drawn from the study which can be summarized as follows. The justification for these conclusions and an extended discussion of the reasoning which supports them, as well as statistical and tabulated information, are contained in the following sections of the Report.

1. The capital requirements of the rural electric program will continue to be large, notwithstanding the dramatic reduction of the rate of growth in energy demand nationwide. Rural electric demand is expected to grow, although at less than historic rates. The requirements for additional capital will be strong in all sectors of the program, but particularly for power supply systems. Based upon assumptions as to load growth and inflation rates utilized in this Report, distribution cooperatives will require $12.5 billion of funding to 1990, while the G&Ts will require commitments in excess of $49 billion. (Part III)

2. The support of the REA has been essential to the success of rural electrification and has been crucial in two respects: (a) in lowering the overall cost of capital, and (b) in assuring access to capital for both the distribution and power supply cooperatives who were otherwise unqualified for funding in the capital markets. The REA guarantee-FFB funding program has proven, in our judgment, to be a unique and irreplaceable capital resource for G&T systems, and essential to the recent very dramatic expansion of the G&Ts. It is equally important, however, to stress that even the limited amount of private G&T financing that has been obtained to date could not have been obtained without strong investor confidence that the REA would continue to play a dominant role in financing power supply sytems, and that the administrative involvement of the REA in rural electric systems could be fully relied upon by lenders in the private sector. FFB access has provided a significant interest and transaction cost advantage to the G&Ts in comparison to funding of the guarantee in the private capital markets. Of much greater importance has been the guarantee itself, which assures funding flexibility and availability of long-term financing regardless of market conditions. (Part IV)

3. The supplemental financing provided by CFC, and to a lesser extent by the Banks for Cooperatives and other lenders, has been successfully integrated into the basic REA program and has enlarged the supply of capital at some higher but still acceptable cost of money. (Part IV)

4. CFC is capable of enlarging its role in providing supplemental financing for distribution cooperatives to the extent necessary. (Part V–B)

5. G&T systems have the potential for expanding their access to private capital, but within the context of a strong continuing REA guarantee program. The Committee on Objectives and Planning projects a total of $49.3 billion of capital commitments for construction programs through 1990. In our judgment, even the fullest possible exploitation of available private financing alternatives would fall short of meeting these requirements. It is particularly important to stress that even the perception of substantially diminishing REA support would limit the full utilization of available private market alternatives—that is to say, that access to the private market will be maximized if a strong ongoing REA financial and administrative commitment is assured. Given this assurance, we believe that G&T systems have several alternatives for expanding their access to private capital. (Part V–A)

6. Individual G&Ts have the capability of entering the market independently if they meet the credit standards of investors, particularly for interest coverage and capitalization ratios. There is an entrance price until the credit becomes familiar, and there will always be periods of market rejection of weaker credits. The poorer G&T credits and those with large start-up and expansion programs will have greater difficulty and may even face denial. Separate financing could set in motion intramural competitive forces which could result in increased overall costs to consumers. (Part V)

7. CFC can plan a vital role in G&T financing while continuing its traditional role with its distribution members. Our Report examines the relative merits of collective action through a new financing vehicle of through CFC directly. CFC has effectively fulfilled not only its original mission of supplementing direct REA loans to distribution members, but also the added one of greatly expanding and diversifying the range of financing services it provides to its distribution and G&T members alike. We believe that CFC, with proper equity support, has a substantial ability to further expand its distribution lending and its guarantee program over time. However, in augmenting CFC's participation in providing credit to G&Ts, it is important that it be done in a manner which economizes on the use of CFC's credit capacity, which has finite limits. (Part V)

8. Collective action holds the best promise for effective private capital market access. Of the financing options we analyzed, we believe the greatest efficiency of access to the private capital markets can be obtained through a collective financing vehicle distinct from but sharing many similar concepts with CFC, and relying in varying degrees on CFC's credit strength and acknowledged favorable market acceptance during its development and operation. We believe that the pooling of individual G&T credits would provide a stronger debt rating for the securities of this vehicle than most G&T systems could command independently, and would provide more effective leveraging of the equity capital resources of G&T members and their consumers than would independent access, thereby implying lower costs. This could be accomplished by forming a new financing entity such as the Power Supply Financing Cooperative outlined in Part V-D of this Report. It should be possible for CFC to provide management services for this new financing entity so that no significant new administrative and operational staff requirements would be imposed. While it would take some time to implement such a program, it would gradually be able to attract significant funding. The concept of strength through unity has served the rural electrification program well, and we believe the rationale that led to the founding of CFC thirteen years ago still applies today.

9. Other suggested financing options are less desirable, or less feasible, than those discussed above:

(a) *Agency status.*—While the designation of CFC, or a similar organization, as a federal agency would provide undeniable benefits in terms of favorable entry to the capital markets at rates only slightly above cost of present FFB funding, establishment of such status runs counter to reducing government involvement. Creation of agency status would require legislation and, at least initially, direct government credit support. Market acceptance of a new agency without direct government credit support would only be gradual, thus limiting the amount of funding obtainable and imposing higher required interest rates than for established agencies. Nor would agency status assure the quantity of long-term funding presently available through the REA guarantee-FFB funding program. (Part V-C)

(b) *Credit insurance.*—Credit insurance is an unproven form of credit support in the taxable market. We are unable to assess its cost, or the amount of credit that such a mechanism could provide. However, this option, which is currently in a developmental stage, could prove to be a method of minimizing credit risks for investors and should be further explored. (Part V-C)

(c) *Banks for cooperatives.*—Under existing policies, the Banks for Cooperatives have done very little co-financing with other financing entities. In addition, the Banks for Cooperatives have largely limited their financing of G&Ts to the funding of REA guarantees already in place. Even if the Banks for Cooperatives exhibited more active involvement in financing power supply systems without a federal guarantee, BC system lending restrictions and eligibility requirements limit the amounts of capital available from this source. (Parts IV-C and V-C)

(d) *Other Alternatives.*—Lease financing, tax-exempt financing, project financing, and a variety of different types of securities—such as commercial paper and bank credit—provide a variety of valid but limited alternatives. (Part IV)

10. Any transfer of a major part of G&T financing requirements from the present government program to direct private market funding would place the cooperative sector in direct competition with the investor-owned utilities for a limited supply of long-term debt. As a result, either some debt demand could go unfilled, or interest rates could be driven up (or both), to the detriment of all utility consumers. (Part V-A)

11. Regardless of the extent to which CFC expands its responsibility for G&T funding, it should strengthen its equity base by a program extending the duration of the subscription CTC's and lowering the cost of the loan CTC's. (Part V-B)

The present federal program, while not perfect, is a satisfactory one. Any reduction in its size and scope will impose significant additional costs upon ultimate consumers while potentially restricting the flow of long-term capital to rural electric cooperatives. A sudden elimination of the federal program would have a dramatic adverse impact; a more gradual, and limited, reduction can probably be absorbed over an extended period of time.

Following is a ranking of the primary long-term financing alternatives for G&Ts. While we have provided brief commentaries, these rankings should be considered within the context of the entire report. The interest rates used were those in effect in November, 1982 and it should be noted that the spread relationships among the various types of obligations will vary with the general level of interest rates.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 26, 1984

Dear Senator Hawkins:

I appreciated the opportunity to appear before your Subcommittee on Agricultural Credit and Rural Electrification on last Thursday, April 12. It may be worthwhile to amplify somewhat on why the provisions for prepayment of Federal Financing Bank loans without penalty in sections 5 and 7 of the NRECA proposed legislation (S.1300) are disadvantageous to the taxpayer.

Were an individual to hold a bank mortgage with the same prepayment provisions that would be applicable under the proposed legislation, when rates fell, he (or she) would prepay the loan and take a new mortgage thereby lowering the interest cost even though the bank making the mortgage loan may not be able to lower the interest cost on its own debt. Thus the borrower gains while the bank loses. On the other hand, if interest rates rise, the borrower would keep the mortgage and not have to pay a higher rate regardless of what happened to the funding cost of the institution. In other words this is a "heads I win, tails you lose" situation, and the "you" in the S.1300 case is the taxpayer. Since it is dependent on the pattern of future interest rates, this provision could turn out to be of little real advantage to the REA cooperatives, while if it does become advantageous to the REA, the taxpayer could be impacted quite adversely if there is REA refinancing without an FFB equivalent opportunity to refinance it owns debt.

I hope this is helpful in explaining why this is such an unattractive provision. Please let me know if we can provide any additional material on this bill.

Sincerely,

Thomas J. Healey

The Honorable
Paula Hawkins
United States Senate
Washington, D.C. 20510

United States
Department of
Agriculture

Office of
Inspector
General

Washington,
D.C.
20250

NOV 16 1983

Honorable Paula Hawkins
Chairman, Subcommittee on Agricultural Credit
and Rural Electrification
Senate Office Building
Washington, D.C. 20510

Dear Chairman Hawkins:

We have reviewed S.1300, the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983.

Our two recently completed audits of Electric Distribution Loans addressed the solvency of the revolving fund and made recommendations for improving its condition. The revolving fund's recent problems stem from the inflexibility of mandatory fixed interest rates (2 percent and 5 percent) on REA lending during periods of escalating market interest rates. When the cost of borrowing materially exceeds the interest rate charged on REA loans, the revolving fund ceases to be self-sustaining.

We recommended that REA seek legislation granting it authority to raise interest rates on REA loans to reflect the cost of Government borrowing and that REA make loans at the increased rate or at a lower rate as determined by a cooperative's financial need. Interest rate provisions contained in S.1300 would not increase the REA loan interest rate to the Government cost of borrowing and would therefore not put the revolving fund on a self-sustaining basis.

Current law provides that REA may require a borrower to obtain up to 30 percent of new financing from the private sector. We also recommended that REA seek legislative changes in the loan making criteria and ratios so that financially strong borrowers would be required to obtain all or increasing percentages of their loan needs from the private sector. We found that many REA borrowers can afford to pay market interest rates with little impact upon user electric rates. User rates charged by financially strong cooperatives would remain competitive with rates charged by investor owned electric utilities in 110 of 117 cases we reviewed. Requiring greater financing through the private sector could reduce the amount of new loan advances from the revolving fund to a level at or below the amount of principal repayments on existing loans. This would improve the fund's financial condition. Even if the revolving fund's interest income and interest expense were balanced by raising loan interest rates to the cost of borrowing, the fund's assets would continue to be depleted if new loan advances exceed principal repaid to the fund from existing loans. This recommendation is also intended to meet program objectives calling for diminishing direct REA assistance as borrowers develop the strength to operate independently.

We further recommended that REA establish criteria to evaluate the need for REA financing according to each cooperative's financial strength and retail electric rates. We believe REA should establish criteria to determine the maximum interest rate a borrower can afford to pay rather than approving all loans at a subsidized interest rate. This should minimize depletion of the revolving fund and assure financing on affordable terms to needy REA borrowers.

We believe that these combined actions can substantially improve the condition of the revolving fund and keep the fund self-sustaining for many years.

Our comments regarding specific provisions contained in S.1300 are included in Enclosure I.

I appreciate the opportunity to comment on S.1300 and would be happy to provide further assistance.

Sincerely,

JOHN V. GRAZIANO
Inspector General

Enclosure

Enclosure I

COMMENTS ON TITLE S.1300

Section 3, (b) -- This section changes the definition of a rural area from a population of 1500 to a population of 2500. This change will have no practical effect because virtually all new Rural Electrification Administration (REA) loans are made to existing borrowers. Our audits found that REA and the Office of General Counsel have interpreted the Rural Electrification Act to require REA to continue making subsidized loans to existing borrowers regardless of changes in the character of their service areas. We identified 80 cooperatives, serving 15,000 or more consumers each, with a high percentage of consumers residing in urban areas. In our opinion, these cooperatives have met the purpose of the Act by providing central station electric service to rural areas. We therefore recommend that the bill be amended to prohibit new loans for electric distribution facilities serving areas which are predominately urban in nature.

Section 4 -- We do not agree with forgiveness of the $7.9 billion owed by the revolving fund to the U.S. Treasury. As a practical matter the forgiveness of $7.9 billion would not solve the revolving fund problems. If the high differential between the REA loan rate and the interest cost on revolving fund borrowings continues, even $7.9 billion will be rapidly depleted. Additionally, the forgiveness would effectively shift REA program costs to the U.S. Treasury. Non-payment of amounts due to the Treasury will reduce Treasury receipts and cause increased Treasury borrowing in future years.

Section 5 -- We do not agree with the provision for downward only adjustments in the interest rates payable on REA revolving fund obligations. This provision effectively shifts REA program costs to the U.S. Treasury. The Treasury cannot refinance its long term debt when interest rates decline and would therefore be forced to absorb the interest costs of downward adjustments in REA obligations.

Section 6 -- The language contained in this section for determining the interest rate on new REA loans is very complex and subject to varying interpretations. Other provisions in the Bill have significant impact on the interest rate determinations. For example, Section 4, which forgives repayment of $7.9 billion to the Treasury would also result in a lower interest rate for REA loans due to the lowering of revolving fund obligations. We have recommended that REA seek a legislative change to authorize an interest rate equivalent to the Government's cost of borrowing. We continue to recommend this change. The standard interest rate should be established by the REA Administrator at or near the cost of Government borrowings and should produce an amount of interest income which, when combined with principal repayments to the fund, would allow amortization of revolving fund debts in a timely manner. If the interest rate is not increased to fully cover the amortization of revolving fund debts, the fund will not become self-sufficient.

The portion of Section 6 beginning on page 6, line 6 contains provisions of eligibility for special rate loans. We believe these provisions would be costly since they provide very low interest rates to a large number of REA borrowers regardless of the borrowers' financial need for special rate loans. Granting eligibility based upon a cooperative's retail electric rates being twice the national average for such rates is a questionable measure of need. Retail electric rates vary significantly by geographic location and based upon the size and efficiency of each cooperative. This provision would provide unwarrented access to low rate loans for inefficient cooperatives and cooperatives in geographic areas with historically high retail electric rates. Low average consumer density and low per capita income are not reliable indicators of a borrowers financial need or ability to pay the standard interest rate.

The legislative provision which starts on page 7, line 12, provides for annual requests by the REA Administrator for appropriations to cover the cost of special interest rate loans approved by REA. If the eligibility provisions cited above are enacted, the appropriations required to cover the cost of special rate loans could be substantial.

Section 7 -- We support the use of guaranteed loans as an alternative to direct REA financing of electric distribution borrowers. We do not, however, support the guarantee of loans made by the National Rural Utilities Cooperative Finance Corporation (NRUCFC). NRUCFC is owned by the rural electric cooperatives which are also REA borrowers. In effect, REA would under this provision, guarantee its borrowers against default by themselves. We strongly recommend against such guarantees as they invite conflicts of interest and legal entanglements. The NRUCFC already benefits from a unique mortgage arrangement with REA, wherein REA and NRUCFC share a first lien on all borrower assets. We do not believe a further guarantee of NRUCFC loans is warranted.

This section of the bill also requires the REA Administrator to approve loan guarantees, accommodations and subordinations at the request of a borrower. On line 23, the word "shall" should be changed to "may". Descretion should be allowed the REA Administrator to assure that adequate collateral and repayment ability exist to protect REA loan exposure.

A second provision contained in Section 7, page 10, line 3, allows the downward adjustment of interest rates on loans guaranteed by REA. We disagree with this provision. Downward only adjustments in guaranteed loan interest rates would deter private sector lenders from participating in REA guaranteed loans. Currently all REA guaranteed loans have been made by the Federal Financing Bank (FFB). This provision could substantially increase FFB costs. If interest rate adjustments are truly needed, provision should be made for increases as well as decreases. FFB could issue variable rate loans which increase as well as decrease, based upon changes in the cost of borrowed money.

Section 8 -- This section renews a legislative requirement that REA continue to use criteria and ratios applicable to loan making activities which are currently in effect. We have recommended that REA seek legislative changes to allow revision of these criteria and ratios. Revisions are needed so that REA may require an increased percentage of financing from the private sector for financially strong borrowers.

Currently REA may require private sector financing of from 10-30 percent of a borrower's loan needs. We recommend that REA be allowed to require private sector financing of any percentage up to 100 percent depending upon the cooperative's financial need.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

November 17, 1983

Dear Senator Hawkins:

Secretary Regan has asked me to respond to your request for the Department's views concerning S. 1300, the "Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983."

Enclosed are copies of the Department's October 4, 1983 report to the Chairman of the Senate Agriculture Committee concerning S. 1300 and my November 8, 1983 letters to the Speaker of the House and Chairman of the House Agriculture Committee concerning H.R. 3050, a bill which is identical to S. 1300.

Sincerely,

W. Dennis Thomas
Assistant Secretary
(Legislative Affairs)

The Honorable
Paula Hawkins
United States Senate
Washington, D.C. 20510

Enclosures

DEPARTMENT OF THE TREASURY
OFFICE OF THE GENERAL COUNSEL
WASHINGTON D.C. 20220

OCT 04 1983

Dear Mr. Chairman:

The Department would like to take this opportunity to comment on S. 1300, the "Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983", which has been referred to your Committee. The Department strongly opposes enactment of S. 1300. It would add to the billions of Federal dollars already granted under existing subsidy programs to rural electric cooperatives. The further large increases proposed under S. 1300 are not justified. The Department's comments on specific provisions of the bill are detailed below.

Under existing law, the REA direct loan program is financed by (1) $7.9 billion of borrowings from Treasury which were outstanding when the Rural Electric and Telephone Revolving Fund was established in 1973 (the 1973 legislation repealed the requirement for the payment of interest to Treasury on this borrowing), (2) the sale to the Federal Financing Bank of certificates of beneficial ownership (CBOs) in the portfolio of direct loans, (3) authorized appropriations, and (4) authority to borrow from Treasury at current Treasury borrowing costs.

Section 4 of the bill would repeal the requirement for repayment of the $7.9 billion of borrowings from Treasury. The Department is not aware of any justification for the proposed cancellation of REA debt. While debt cancellation could be justified to the extent of realized loan losses, this justification is absent in the case of the REA program. Moreover, since this additional $7.9 billion of financing for the program would be provided outside of the budget/appropriations process, it would constitute backdoor financing. Accordingly, the Department is opposed to section 4.

Section 5 would authorize the Administrator to repurchase without penalty CBOs sold to the FFB whenever the interest rate on an outstanding CBO is at least 100 basis points higher than the current FFB rate. Thus, in a period of declining market interest rates, the Administrator could continuously refund the entire portfolio of some $3.3 billion of CBOs at successively lower interest rates and then simply wait out any periods of rising market rates. This proposal would provide substantial benefits to the fund at the expense of the FFB and the Treasury. Accordingly, the Department is opposed to section 5.

Section 7 would provide a similar rollover privilege for guaranteed borrowers from the Federal Financing Bank except that such rollovers could only occur every 7 years. That is, if the current FFB lending rate were at least 1 percentage point below the rate on an outstanding guaranteed loan, the borrower could request that the loan be refinanced without penalty at the current FFB rate. This proposal suffers from the same criticism as the proposal to refinance CBOs discussed above. FFB and REA have agreed in principle to permit REA-guaranteed borrowers to fund projects with rollovers of short-term debt during the up to 35-year period when an advance is outstanding. The contractual terms, which are now being worked out between FFB and REA, would be more flexible than the legislative language proposed in section 7 of the bill and would recognize the rights and obligations of all of the parties to the guaranteed loan contract.

Under existing law, REA makes direct loans at 5 percent (the standard rate) and at 2 percent (the special rate). Section 6 would amend existing law to authorize the Administrator, from time to time, to establish the interest rate for new loans made during a given period so that the interest income from new loans just covers the Administrator's anticipated interest expense on new borrowings during that period. Standard loans would bear interest at the rate so determined, but not less than 5 percent. Special loans would bear interest at not less than 2 percent nor more than one-half the standard loan rate. We understand that the effect of section 6 would be to increase the standard loan rate to about 6 percent.

Experience with Federal credit programs demonstrates that fixed interest rates, such as the 5 percent and 2 percent rates prescribed in the REA statute, produce perverse and unintended variations in interest rate subsidies as market rates of interest vary. This results in inequities among borrowers using the program at different times and in extraordinary demands for Federal loans at times of highest market rates of interest, which are also likely to be the times of greatest inflationary pressures and need for budgetary restraint. For example, at the current cost of long-term Treasury borrowing of about 12 percent, the cost of making a typical 35-year loan at 5 percent in the amount of $3 million is the same as the cost of providing an outright grant of $1.5 million and requiring the remaining $1.5 million to be paid with interest at 12 percent. Yet in 1973, when the 5 percent rate was established for the REA program, the Treasury's long-term borrowing rate was only about 7 percent, so the cost to the Government, and the subsidy to new borrowers, has risen substantially over the past decade because of the increase in market rates of interest rather than an increase in the need for the subsidy. The Department, therefore, opposes interest subsidies of this nature.

The Treasury has long maintained that the benchmark interest rate for Federal lending programs should be the current cost of Treasury borrowing for a period comparable to the maturity of the loan. The essence of the argument is that while the Treasury does not enter the market to borrow a specific amount for a specific maturity to finance a loan in that amount at that maturity, it is compelled to have a comparably greater amount of debt outstanding over the life of the loan. Thus, the best measure of the cost of the loan is the current market borrowing cost for comparable maturities. Any interest rate subsidies deemed necessary should be provided at a fixed spread below the Treasury borrowing rate. Under this approach, the interest rate subsidy is explicit. Accordingly, the Department is opposed to section 6 of the bill.

Under existing law, the REA Administrator is authorized, but not required, to guarantee loans to rural electric and telephone borrowers and to subordinate direct loans to other financing obtained by such borrowers. Section 7 of the bill would amend existing law to require the Administrator to guarantee such loans and to subordinate REA direct loans at the request of the borrower. Such subordination would substantially increase the Government's risk. Also, since eligible borrowers include States and municipalities, the guarantee and/or subordination of the aforementioned loans would result in the Federal guarantee of tax-exempt obligations.

The Administration is strongly opposed to Federal guarantees of tax-exempt obligations. Placing the credit of the United States behind a tax-exempt obligation creates a security that is superior to direct obligations issued by the U.S. Treasury and is contrary to the spirit of the Public Debt Act of 1941, which prohibits direct issuance by Federal agencies of obligations the interest on which is exempt from Federal income taxation. Federal guarantees of tax-exempts also have adverse effects on the municipal market, because they create securities which are superior to all other tax-exempt securities issued by State and local entities. Consequently, such guarantees add to the pressures on the municipal bond market, crowd out other, less creditworthy municipal borrowers, and increase the borrowing costs of all municipal borrowers. A guarantee of a tax-exempt obligation is an inefficient means of Federal financing because the revenue loss to the Treasury greatly exceeds the interest benefits to the borrower of the tax exemption. Since 1970, Congress has enacted at least 24 statutes which preclude Federal guarantees of tax-exempts and in many cases authorize more efficient means of providing Federal credit assistance to the affected borrowers. As indicated in the enclosed list, these statutes affect virtually every sector of the economy -- agriculture, community facilities, education, energy, housing, rural business and economic development, and transportation. Accordingly, the Department is opposed to section 7 of the bill.

The rural electric cooperatives have benefitted from a wide range of subsidies, including subsidized direct loans and 100 percent loan guarantees, tax-exempt status, retention of essentially tax-exempt status while taking advantage of tax incentives (e.g., Safe Harbor leasing) available to fully taxable entities, tax-exempt municipal bonds for pollution control equipment, and preferential access to low cost Federal power. No justification for the large increases in subsidies and U.S. Government risk proposed by the bill has, however, been provided. Thus, no further subsidies are warranted. We, therefore, strongly urge the Committee to reject this legislation.

The Office of Management and Budget has advised that there is no objection to the submission of this report to your Committee, and that enactment of S. 1300 in its present form would not be in accord with the President's program.

Sincerely,

Jordan Luke

Margery Waxman
Acting Deputy General Counsel

The Honorable
Jesse A. Helms, Chairman
Committee on Agriculture,
  Nutrition, and Forestry
United States Senate
Washington, D.C. 20510

Enclosure

Statutes which preclude Federal guarantees of tax-exempt obligations

1. Loans for modernization and construction of hospitals and other medical facilities; P.L. 91-296, June 30, 1970, 42 U.S.C. 291j-7(e). 1/2/3/

2. New Community debentures; P.L. 91-609, December 31, 1970, 42 U.S.C. 4514. 2/3/

3. Water and waste facility loans sold out of the Agricultural Credit Insurance Fund; P.L. 91-617, December 31, 1970, 7 U.S.C. 1926(a)(1). 2/3/

4. Farm Credit Administration member institution guarantees; P.L. 92-181, December 10, 1971, 12 U.S.C. 2204.

5. Academic facilities loan insurance, P.L. 92-318, June 23, 1972, 20 U.S.C. 1132c-5.

6. Washington Metropolitan Area Transit Authority obligations; P.L. 92-349, July 13, 1972, D.C. Code 1-1441 note, 2/3/

7. Loans sold out of the Rural Development Insurance Fund; P.L. 92-419, August 30, 1972, 7 U.S.C. 1929a(h). 2/

8. Vocational rehabilitation facilities mortgages; P.L. 93-112, September 26, 1973, 29 U.S.C. 773(c).

9. National Railroad Passenger Corporation guaranteed obligations; P.L. 93-146, November 3, 1973, 45 U.S.C. 602(g).

10. Loan guarantees for initial operating costs of health maintenance organizations; P.L. 93-222, December 29, 1973, 42 U.S.C. 300e-(c)(3). 2/

11. Loan guarantees to assist the economic development of Indians and Indian organizations; P.L. 93-262, April 12, 1974, 25 U.S.C. 1451.

12. State housing finance and State development agency obligations; section 802 of P.L. 93-383, August 22, 1974, 42 U.S.C. 1440. 2/3/

13. Guarantees of obligations issued by coastal State and local governments to finance projects associated with the development of Outer Continental Shelf energy resources; section 7 of P.L. 94-370, July 26, 1976, 16 U.S.C. 1456a. 2/3/

14. Guarantees of Virgin Islands Bonds; P.L. 94-392, August 19, 1976, 48 U.S.C. 1574b. 2/

15. Loan guarantee program for acquisition of property (urban renewal); section 108 of P.L. 93-383 as amended by P.L. 95-128, October 12, 1977, 42 U.S.C. 5308. 2/3/

16. Guarantees of obligations issued by State and local governments to finance essential community development and planning occasioned by Federally assisted alternative fuel demonstration facilities; section 19(k) of the Federal Nonnuclear Energy Research and Development Act of 1974, as added by section 207(b) of P.L. 95-238, Feb. 25, 1978, 42 U.S.C. 5919. 2/3/

17. Guarantees for startup and construction costs of municipal or industrial waste treatment and synthetic fuels demonstration facilities; section 19(y) of the Federal Nonnuclear Energy Research and Development Act of 1974, as added by P.L. 95-238, Feb. 25, 1978, 42 U.S.C. 5919. 2/3/

18. New York City loan guarantees; section 103 of the Internal Revenue Code of 1954, as amended by section 201 of P.L. 95-339, August 8, 1978, 26 U.S.C. 103. 2/

19. Loan guarantees of the National Consumer Cooperative Bank; section 108(c) of P.L. 95-351, August 20, 1978, 12 U.S.C. 3018.

20. Guarantees of combination financing for hospitals and guarantees of combination refinancing for multifamily housing projects; section 242 of the National Housing Act, as amended by section 315 of P.L. 96-153, December 21, 1979, 12 U.S.C. 1715z-7.

21. Loan guarantees to assist the Chrysler Corporation; section 11 of P.L. 96-185, January 7, 1980, 15 U.S.C. 1870.

22. Revenue bonds guaranteed or otherwise secured by the United States Synthetic Fuels Corporation; section 155 of P.L. 96-294, June 30, 1980, 42 U.S.C. 8755. 2/3/

23. Loan guarantees for municipal waste energy projects; section 233 of P.L. 96-294, June 30, 1980, 42 U.S.C. 8833. 2/3/

24. Guarantees of obligations issued to finance ocean thermal energy facilities; section 1110 of the Merchant Marine Act, 1936, as added by section 203 of P.L. 96-320, August 3, 1980, 46 U.S.C. 1279c. 2/

1/ Superseded by P.L. 93-641, January 4, 1975, 42 U.S.C. 300q.

2/ Statutes which authorize guarantees of taxable municipal obligations.

3/ Statutes which authorize interest subsidies on guaranteed taxable municipals.

THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

November 8, 1983

Dear Mr. Speaker:

The Cabinet Council on Economic Affairs (CCEA), on behalf of the Administration, has reviewed H.R. 3050, the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983. As Secretary of the Treasury and Chairman Pro Tempore of the CCEA, I must advise you that we have grave reservations about a number of the provisions of H.R. 3050.

While we recognize the need for legislation to restore balance to the Rural Electrification and Telephone Revolving Fund, as the Department indicated in its October 4, 1983, report to Chairman de la Garza (copy enclosed), the bill as currently drafted is defective and unnecessarily costly.

We are particularly concerned with the following provisions:

--Repeal of the requirement to repay $7.9 billion of Rural Electrification Administration (REA) borrowings from Treasury.

--The authority to repurchase without penalty Certificates of Beneficial Ownership (CBO) sold to the Federal Financing Bank (FFB) whenever the interest rate on an outstanding CBO is 1 percentage point higher than the current FFB rate.

--The authority for a similar rollover privilege for guaranteed borrowers from the FFB.

--The provisions for determining interest rates on REA loans.

--Federal guarantees of tax-exempt obligations and subordination of REA interests to the interests of other lenders.

--Broader criteria for the special (2%) interest rate on insured loans.

While we support an effort to accomplish the stated aim of the bill, i.e., to stabilize the revolving fund, enactment of H.R. 3050 in its present form would not be in accord with the President's program.

Sincerely,

Donald T. Regan

Donald T. Regan

The Honorable
Thomas P. O'Neill, Jr.
Speaker of the House of
 Representatives
Washington, D.C. 20515

Enclosure

cc: The Honorable
Edward R. Madigan

The Honorable
Ed Bethune

State of North Dakota,
Executive Office,
April 12, 1984.

Hon. Paula Hawkins,
Chairman, Subcommittee on Agricultural Credit and Rural Electrification, Senate Agriculture Committee, U.S. Senate, Washington, DC.

Dear Senator Hawkins: The Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act, S. 1300, is of great importance to the thousands of rural area consumer members served by electric and telephone cooperatives in North Dakota and to the 25 million consumer members throughout the United States. This Act will provide the financial stability necessary to assure a sound and healthy future for America's rural electrification program.

I previously submitted a statement of record to be filed with your subcommittee in support of the Revolving Fund Act. That statement was presented on behalf of 13 western state governors. In light of the subcommittee's present consideration of S. 1300, I bring our support of this legislation to the attention of its members and urge your favorable consideration and recommendation of its passage.

The creation of the rural electrification and telephone program resulted in one of the most successful partnerships to form between government and its citizens. It has provided rural America with dependable and reasonably priced electric power and telephone service.

American agriculture is a "world class" industry. It will remain so only if it is allowed to compete in the world market. Our rural electrification and communications systems are vital to keeping our nation's agriculture competitive.

Your favorable consideration of S. 1300 will assure the continuation of financially sound and reliable electric and telephone systems to serve the needs of agriculture and the nation.

Sincerely,

Allen I. Olson, *Governor.*

National LP-Gas Association,
Arlington, VA, May 23, 1984.

Hon. Paula Hawkins,
Chairwoman, Subcommittee on Agricultural Credit and Rural Electrification, U.S. Senate, Washington, DC.

Dear Chairman Hawkins: The National LP-Gas Association (NLPGA) offers its comments on S. 1300, the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983, and the House-passed companion legislation (H.R. 3050). NLPGA requests that these comments be made a part of the record of the May 15, 1984, hearing held by your Subcommittee on this legislation.

NLPGA is the national trade association of the LP-gas industry with a membership of about 4100 including 47 affiliated state and regional LP-gas associations representing all 50 states. Members of NLPGA represent all segments of the LP-gas (principally propane) industry including producers, transporters, wholesalers and retailers, as well as the manufacturers and distributors of associated equipment and appliances. The largest single group of NLPGA members are retail propane distributors.

The LP-gas industry plays an important part in the American economy. 60 million people use propane gas for one or more applications; 22 million of these depend on propane for their residential energy needs. 6.3 million or about one fourth of the total homes in rural America depend on propane; this includes approximately one-half of all of our nation's farms. The capital investment in the propane industry is well in excess of $7.5 billions, and more than 86,000 persons are involved in the LP-gas distribution process.

In short, the members of the LP-gas industry are the nation's fourth leading suppliers of energy. LP-gas, commonly known as propane or bottled gas, is a fuel used in the household, on the farm, and in a variety of commercial and industrial applications as a source of heat, power or refrigeration. The largest residential market of LP-gas is in rural areas which makes the LP-gas retailer a direct competitor of the REA co-op.

NLPGA strongly objects to continued governmental subsidization of REA co-ops in direct competition with private enterprise.

While NLPGA applauds the laudable goals which prompted the establishment of the Rural Electrification Administration in 1936 and while we recognize that this legislation has served well its purpose of bringing electricity to rural homes, we believe that the program has achieved its purposes and in large measure outlived its usefulness. LP-gas dealers and the customers they serve in many cases are rural citizens who are fully aware of the benefits that the REA program has brought to America. It must be recognized, however, that 99% of U.S. farms today have electricity and 95% have telephone service. Continuation and further promotion of tax subsidies and low interest loans for REA co-ops represents a continued and unnecessary drain on scarce federal revenues while injuring taxpaying private businesses such as members of the LP-gas industry.

NLPGA and its predecessor organization, the Liquefied Petroleum Gas Association, Inc., have long called for equity in this matter. For over 20 years we have presented examples to Senate and House Committees of how electric cooperatives have been "buying" LP-gas customers with our tax dollars. Time and again NLPGA has presented concrete evidence of co-ops which have offered appliance installation financing deals on a give-away basis or at unrealistic low rates of interest; co-ops which have offered bounty or cash allowances to customers who will turn in their LP-gas tanks and go electric; co-op rate structures with built-in penalties if the customer uses privately furnished fuel; and, unfair and distorted misrepresentations in REA co-op advertising of the safety and economies of gas.

It is one thing for a private business to engage in such unscrupulous and underhanded activities, but it is even worse when that business enjoys both tax exempt status and is able to secure long term financing at interest rates of between 2% and 5%. Propane retailers not only pay taxes but must compete in private financial markets at interest rates of 12%, 15%, or more. As the General Accounting Office (GAO) noted in its report dated January 5, 1983, entitled "Legislation Needed to Improve Administration of Tax Exemption Provisions for Electric Cooperatives," (GAO/GGD-83-7): "We estimate that in 1980, as a result of REA loan programs, cooperatives saved nearly $340 million over the cost of private financing."

The GAO found that the combination of low interest loans and federal tax exemption has made electric cooperatives more successful in many instances than investor owned utilities. In fact, GAO stated that since 1960, electric cooperatives have acquired 22 investor owned utilities, whereas investor utilities have acquired only 4 electric cooperatives while being unsuccessful in 33 other attempts. Finding that electric cooperatives today more closely resemble investor owned utility companies and are becoming large conglomerates compared to the small associations they may once have been, GAO recommended that Congress enact changes that would more realistically reflect the "for-profit" nature of these electric cooperatives.

So too, NLPGA now urges the Senate to look with disfavor on current proposals to "bail-out" the electric cooperatives at the further expense of taxpayers. For decades, the government has been subsidizing electric cooperatives and their customers at the expense of competing business. The ignominy of this course of action was only enhanced further by the recent announcement that an electric cooperative in Spokane, Washington, the Inland Power and Light Company, will begin operation of a retail propane distribution business in direct competition with other propane distributors next month.

We urge your Subcommittee to disapprove S. 1300 and H.R. 3050 and put a halt to this continued intrusion of the federal government into private enterprise. It not only is patently unfair but it constitutes an unnecessary drain on sorely needed revenues. Moreover, if Congress would act to eliminate the tax exemption granted electric co-ops and lift the heavy hand of government from the scales of competition, all tax revenues would be enhanced.

Respectfully submitted,

DANIEL N. MYERS, *Vice President,*
Government Relations and General Counsel.

LUBBOCK RADIO PAGING SERVICE, INC.,
Lubbock, TX, May 10, 1984.

Hon. PAULA HAWKINS,
Hart Senate Office Building,
Washington, DC.

DEAR SENATOR HAWKINS: A matter of real concern to our Company is soon to be considered in the Senate. It is Senate Bill No. 1300, designed to maintain the Rural Electrification Administration's ability to make loans to rural and other small electric utilities. The occasion for the concern is that this legislation has only recently passed the House, and hopefully more attention will be given it in the Senate. I feel it is not in keeping either with the President's desire to encourage the free enterprise system, nor is it in keeping with trying to cut our deficit spending.

Specifically, my concern is that this Act, which embarked the Rural Electrification program some 48 years ago (at a time when it was truly needed) is now exceeding its guidelines. While initially established to bring electricity and telephone service to rural areas outside those boundaries served by a public utility or a private company, co-ops now appear to be spreading out in other areas under the guise of telephone service. I would doubt that there are any areas, particularly in West Texas, where there is a need for a rural electrification program based on unavailability of service by a free enterprise, tax paying company.

I have no quarrel with loaning REA money to develop isolated rural areas where commercial service is not available—if, in fact, 48 years after its inception, there are still such areas—but co-ops now, at least in this area, are extending their government financed services into metropolitan areas where they compete with companies like ours, who must borrow money at commercial rates, and show a profit to remain in business.

I can specifically speak to one co-op. Poko-Lambro Telephone Cooperative telephone service area's northern boundary is sixteen miles south of Lubbock. Their headquarters building is located on the northern boundary along with an antenna for their mobile telephone and paging channels. They are presently serving mobile telephone subscribers who are based in, and reside in Lubbock. Some of these subscribers were formally subscribers of Lubbock Radio Paging Service who switched because of the greatly reduced rates offered by the Co-op brought about by their non-profit status and low interest REA financing.

On December 21, 1983, Poko-Lambro applied to the FCC for a satellite transmitter on their paging frequency to be located in downtown Lubbock, about 18 miles outside of their authorized rural telephone service area. A copy of the FCC Public Notice indicating this application was granted on May 1, 1984, is enclosed. I do not believe it is the intent of Congress for REA funds to be used in metropolitan areas to compete with existing carriers who are providing more than adequate service to the public. The population of Lubbock is over 200,000.

I am also terribly concerned about "forgiving" $7.9 billion that co-ops owe the Treasury under this program. Being a taxpayer, I unilaterally object to forgiving monies owed the Treasury.

The REA program is now operating under a different set of rules than those for which they were initially established. It appears they have expanded their definition of the type service they should/can offer, into whatever type of business they feel they would like to be involved in. They can do it without concern for paying taxes, borrowing money at commercial rates, or making a profit. They are not beholden, it appears, to anyone.

I sincerely appreciate your consideration of the above.

Sincerely,

ETHEL M. MCLEOD,
Chairman of the Board.

Enclosure.

ACTIONS TAKEN—MAY 2, 1984

Poka-Lambro Rural Telephone Cooperative, Inc. (KNKB357) granted permit and mod. of lic. for additional facilities to operate on 158.10 MHZ at 1220 Broadway, Lubbock, Texas. (21187-CD-P/ML-1-84).

ELECTRO-CRAFT, INC.,
Rapid City, SD, June 1, 1984.

Hon. PAULA HAWKINS,
Chairwoman, Agriculture Credit and Rural Electric Subcommittee, Russell Senate Office Bldg., Washington, DC.

S-1300 BILL—AN URGENT PLEA

DEAR SENATOR HAWKINS: I write this to you after having read the present provisions of the subject bill including the "telephone service" provisions. The original Act of 1936 was a godsend in relieving a lot of personal drudgery and opened the door for improved productivity and very real conveniences. I know because my family benefited and have been thankful for its passage. The thrust of S-1300 is entirely a different picture as I see its application to services available today.

Golden West, a local cooperative, commenced offering paging and plans to offer mobile telephone service very soon to the residents of Rapid City and the immediate surrounding area. We, ECI, have made available such services for many years. Further, we have made available comprehensive services to rural communities, farm and ranch areas covering tens of thousands of square miles for years. Our present systems' capacities are now utilized by 20 to 50 percent. We also have had competing services for years.

Comes now Golden West, the cooperative, to offer only a portion of the broad services available from ECI, and only in the largest community area in our half of the State of South Dakota. Further, Golden West recently testified at a recent Public Utilities Commission hearing that they have no intention or plans now of offering services in the "really wide open spaces" areas in our state. ECI serves all areas in our part of the state now through past plans, designs, and intentions.

A public need for special treatment of cooperatives that offer nothing new in rural, let alone urban areas, totally escapes me.

A separation of funds, notwithstanding a separation of revenues and costs within the telephone funds in view of proposed expanded services, can only be considered a matter of provision and not one of realistic practice.

The "forgiveness" of the 6-8 billions of dollars of the loans is tantamount to the cooperatives receiving free equipment in an industry that is capital intensive. Further, as a local competitor of ours, such a zero cost of capital enables unrealistically low charges for services rendered to the public. Under such an arrangement, we as part of the taxpaying public, would be helping buy equipment for a competitor so they could further erode our customer base, our revenues, and our modest return on investment. Beyond belief? No, only too true.

The reduced cost of capital, enabled through government financial arrangements for cooperatives does modify the effect described above. Modified in quantity only is the effect and there is no effect in the character whatsoever.

Our local cooperative does not need protection from us, although the reverse may be true. Their annual revenues total into the millions of dollars; ours are less than one-half of one.

I urgently plead with you to help guide the committee in preparing any needed legislation that will not decimate hundreds of small businesses across our country. Our small businesses truly brought personal and mobile telephone communications to small urban and to rural America. It was done at our own personal financial risk and with no governmental aid. It's a matter of record.

The cooperative in our part of the country does not need S-1300, nor does the public, either in service or in taxes. I know that we sure don't.

Thank you for reading this and for your time.

Sincerely,

W.O. Thompson,
President, Owner, and Operator.

Able Communications,
Florence, SC, May 4, 1984.

Senator Paula Hawkins,
U.S. Senate,
Washington, DC.

Attention: Ron Boenau.

Dear Senator Hawkins: I am advised that you will be conducting hearings in the near future concerning H.R. 3050, which will continue to provide low cost loans to rural electric and rural telephone cooperatives.

Here in the sixth district of South Carolina my company, Able Communications, Inc., is in direct competition with Farmers Telephone Cooperative, Inc., in providing mobile telephone and tone and voice paging services.

Farmers has been providing mobile telephone and tone only paging for over seven years and has never broken even. In 1978, 1979 and 1980 they actually lost over $42,000.00 according to reports filed with F.C.C. These reports were discontinued after 1980 and Farmers cannot show that they have ever broken even.

Farmers operation is 92% debt capital, supplied by R.E.A. They are using a government subsidy to provide their paging service at a rate which is 35% lower than our rate. The enclosed documents will clearly show that Farmers has no idea of its actual costs, and their management has the attitude that they really don't care. With an unlimited supply of money at 5% or lower rates, who can really blame them?

We believe that Congress should prohibit telephone and electric co-ops from engaging in sideline businesses in direct competition with private companies unless they can prove a need which is not being met by us. When all the tax paying companies have been driven into bankruptcy by the subsidized co-ops, who will then provide the money?

The enclosed testimony of H. Randolph Currin, Jr. indicates that Farmers would require a return of 28.34% on rate base to maintain a T.I.E.R. of 1.5, which is the minimum required by R.E.A. Farmers tone and voice paging rate, as presently being used, results in a negative rate of return on rate base.

I would like to come to Washington to testify in these hearings and if possible, I will have Mr. Currin there too. Please let me know if I will be permitted to testify.

Thank you.

Sincerely,

DAVID A. THOMY, *Secretary-Treasurer.*

ABLE COMMUNICATIONS,
Florence SC, May 18, 1984.

Hon. PAULA HAWKINS,
U.S. Senate,
Washington, DC.

DEAR SENATOR HAWKINS: These questions have been raised as the result of my company's experience in competing with an R.E.A. Co-op:

Are R.E.A. telephone co-ops allowed to cross subsidize from monopoly land-line services to competitive ventures?

Are R.E.A. telephone co-ops under any regulations to identify the individual costs of each service offered?

Are R.E.A. telephone co-ops penalized for misuse of revenues generated by R.E.A. financed assets?

Can private enterprise compete with R.E.A. subsidized telephone co-ops?

My company is Able Communications, Inc., a small Radio Common Carrier licensed by the F.C.C. since 1966. We operate in 9 counties of South Carolina, serving 1600 customers in a rural area with 10 paging transmitters and 3 mobile telephone transmitters. Our competition is Farmers Telephone Co-op which has offered mobile telephone service for over 10 years and tone only paging service for over 7 years.

Farmers has filed forms with the F.C.C. for the years of 1978–1980 (forms discontinued thereafter) showing losses in every year for a total loss of over $42,000.00. In P.S.C. depositions, (we could provide if requested), the comptroller of the phone company did not know where these figures came from because the company has never set up accounts to track costs for mobile telephone and paging. He further stated that he did not know if they have ever made money or broken even because of this lack of cost information. Farmers Co-op has recently established a tone and voice paging system at a rate 35% below my rate. To establish costs for this service they first-picked the rate they intended to charge! In the comptroller's work papers, obtained at the time of his deposition, he worked backward to allocate costs. Using this method they will never identify any real expenses generated by the paging service. They will subsidize this new service as they have their existing paging and mobile service by their telephone income generated by R.E.A. low interest money.

To answer my question: "Can private enterprise compete with R.E.A. subsidized co-ops?" No!

I make the following recommendations from experience:

1. Make the co-ops form separate subsidiaries when competing with free enterprise companies. (Telephone income should be reinvested in phone company operations not used to subsidize competitive ventures.)
2. Use real world accounting standards, "The Uniform System of Accounts" used is grossly inadequate for competitive business.
3. Require periodic management audits by objective outside auditors with the requirement that the study be made public to the "owners".
4. Establish penalties for unfair competition and establish an independent body to receive complaints with broad investigative and rule making authority to stop under cost pricing.
5. Your present bill, S-1300, has had no input as to its effect on R.E.A. telephone co-ops and their competitors. In a time when the telecommunications industry is encouraged to become competitive, your bill will create havoc with R.E.A. telephone competitors.
6. S-1300 allows R.E.A. telephone companies to receive low interest money for new competitive services that compete with free enterprise. In the attached news

article, R.E.A. states it will lend money for cellular mobile telephone for a pay back period of 35 years. An average cellular investment could be $1,000,000.00. R.E.A. lends to 1028 phone companies. If each borrower used this amount, you will have over $1,028,000,000.00 used for competition with private enterprise. I do not think that you intend to subsidize R.E.A. competition with private business. Nor do I think that you intend that they should use the same people, assets and money generated from R.E.A. activities to underprice the free market system.

An indication of the present attitude and position of the R.E.A. is shown by a letter written to my congressman stating that Farmers was incompliance with its accounting requirement even though R.E.A. had documents stating that they had not set up accounts to track costs involved in the mobile telephone and paging costs service. It appears R.E.A. is there only to insure that R.E.A. money buys the intended assets. Does it lack the authority and/or desire to enforce accurate accounting methods?

I truly believe that even with the above suggestions that congress should prohibit co-ops from engaging in sideline businesses in direct competition with private companies unless they can prove a need which is not being met by private enterprise.

When All the Tax Paying Companies Have Been Driven Into Bankruptcy by the Subsidized Co-ops, Who Will Then Provide the Money?

I respectfully request that you make this document a part of the hearing record.

Thank you.

Sincerely,

David A. Thomy, *Secretary-Treasurer.*

Enclosure.

House of Representatives,
Washington, DC, February 16, 1984.

Re: Mr. David Thomy, Able Communication, Florence, SC, and Farmers' Cooperative, Kingstree, SC.

Mr. William W. Kelly,
Director, Southeast Area Telephone REA, South Building, Department of Agriculture, Washington, DC.

Dear Mr. Kelly: I have received an inquiry from a constituent of mine in the private communications industry regarding the use of REA funds for telephone cooperatives to operate beeper and paging services as well as cable television service for their customers.

While I understand that REA funds cannot be used to subsidize other services, such as beeper service, my constituent feels that the cooperative must identify cost and accounting methods in each service area (CATV, beepers, telephone service) before the cooperative is allowed to implement other services. My constituent believes that the use of allocation as opposed to a true cost accounting basis does not allow private enterprise the opportunity to compete fairly with the cooperative.

I understand that Mr. Thomy has spoken and corresponded with Hank Buchanan of your staff who has documentation from Mr. Thomy. I would appreciate any information and assistance you could provide on this matter. I look forward to your reply.

With best regards, I am

Sincerely,

Robin Tallon,
Member of Congress.

U.S. Department of Agriculture,
Rural Electrification Administration,
Washington, DC, March 9, 1984.

Hon. Robin Tallon,
House of Representatives,
Washington, DC.

Dear Congressman Tallon: This is in response to your letter of February 16, 1984, regarding the use of Rural Electrification Administration (REA) funds for telephone cooperatives to operate beeper and paging services as well as cable television for their customers. The money to operate these services comes from the revenue derived from the particular service and not from REA loan funds nor from the revenue of the cooperative's telephone service.

Your constituent has a question or concern about the accounting methods in each of the above service fields. The Farmers Telephone Cooperative is subject to the jurisdiction of the South Carolina Public Service Commission which prescribes that telephone utilities keep their books and records in conformance with the Federal Communications Commission's (FCC) Uniform System of Accounts (USoA). REA's accounting staff and Farmers' certified public accountant find that Farmers is in compliance with the USoA as well as REA's accounting requirements.

We suggest that your constituent contact the South Carolina Public Service Commission to inquire about allocation of costs in the justification of Farmers' rates for its paging service. If we can be of further assistance, please let us know.

Sincerely,

HAROLD V. HUNTER, *Administrator.*

REA LOANS AVAILABLE FOR CELLULAR

WASHINGTON.—Cellular radio telephone operators may be eligible to receive from $500,000 to $30 million through the Rural Electrification Administration's Telephone Division, according to spokesmen from the agency.

In 1939 Congress passed legislation which provided the entire United States with electrical service, by arranging for the Rural Electrification Administration to subsidize companies who would not find economic feasibility in serving very rural areas. The act was amended in 1949 to include provisions for loaning to telephone companies who wished to wire rural areas. William Kelly, director of southeast area telephone for REA said, "cellular is a telephone service," and no modifications of the current law would be necessary should cellular radio telephone companies wish to apply for REA funding.

However, before the REA funding is approved several criteria must be met which would restrict major market cellular companies from applying at all. The criteria are: service of a town with less than 1500 persons; filing of a loan application; and submission of a feasibility study to the one of five regional directors in the REA.

Once an applicant's paperwork has been received by the REA, engineers examine the feasibility study, and the area director decides, based on policy, whether to grant or deny the application.

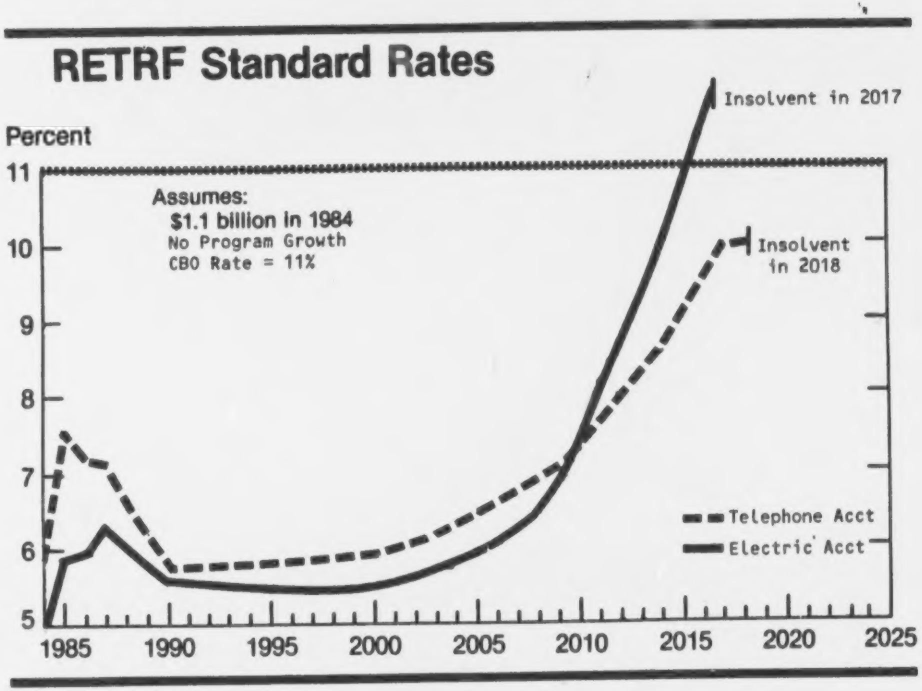
Interest rates for the available loans can range from a low of two percent, which is very unlikely according to Jerry Schrange, chief of Systems Engineering Branch, to the current cost of money from the government, approximately 11.5 percent. Terms can be negotiated for 35 years or less. Schrange said, "We expect that a lot cf our present borrowers will be borrowing in those smaller markets." (Cellular radio markets and beyond).

The REA loan funds only to wireline telephone companies. However, Kelley stated that should a pocket of subscribers need service, a nonwireline carrier could be considered for a loan. Kelly indicated that several inquiries about the available funds have been made, yet, no applications have been filed to date.

Currently the REA loans between 4½ to 5 million dollars to 1000 entities who provide telephone service to rural subscribers.

R.C.R. May 7, 1984.

STANDARD RATES UNDER S. 1300



(The following material is an extract from a committee print entitled "Task Force Report on the Department of Agriculture", Committee on Agriculture, Nutrition, and Forestry, July 1983.)

SUMMARY

Rural Electrification Administration (REA)

Electricity and telephones are now available to 99 percent of rural America. The Rural Electrification Administration (REA) is still making low-interest distribution loans and providing detailed regulations on what borrowers do. It has made power-generation loans that have over-runs and are located in surplus power areas.

Savings or cost avoidance of $44 million in one year, or $145 million for three years, could be realized if Congress enacts the Task Force recommendations. About $3 to $4 billion in Government borrowing would be shifted to the private sector over the next three years.

Generation and transmission loans should be limited to those already committed and those that can be fully justified by detailed study of need. Present borrowers, when financial standards are met, should use more nongovernmental funds. These funds are available at private competitive rates. In addition, REA should reduce borrower regulations to be more in line with credit supervision rather than supervision of operations.

Overview

The Rural Electrification Administration (REA) was established in 1936 to provide loans to eligible cooperative borrowers and to extend electric service to unserved, rural areas. The REA moved gradually into making loans to power supply cooperatives in addition to power distribution borrowers. Prior to 1973, the annual amount of long-term financing REA provided to power supply borrowers in a single year had not exceeded $200 million. Following the Rural Electrification Act amendments of 1973, REA power supply borrowers had access to loan guarantees provided through the Federal Financing Bank (FFB) at a rate of one-eighth of 1 percent above the current market for U.S. Government obligations of comparable maturity. REA's lending programs moved from on-budget to off-budget status.

Since 1973, the amount of annual loan guarantees extended increased rapidly, doubling in cumulative amount outstanding from $13.5 billion in FY 1978 to $31.6 billion in FY 1980. From an overall Government perspective, the sheer magnitude of these guarantees (some 20% of FFB's off-budget lending at one point) has contributed to Government borrowing in the credit markets, exposed interest rates to upward pressures, and affected debt management policy. REA's off-budget status and that of other credit lenders has made control over the growth of Federal credit a more difficult task.

Ninety-nine percent of rural America now has electricity and telephones available. The REA is still making low-interest distribution loans and providing detailed regulations on what borrowers do. In addition, they have made some power-generation loans that have overruns and that are located in surplus power areas.

AG 56: Reduce Generation and Transmission Loans

Issue and Savings

The Government should begin extricating itself from loans for the generation and transmission (G&T) of power by reducing annual loan guarantees by $1.7 billion by FY 1986 (i.e., from $4.7 billion annually in 1983 to $3.0 billion annually in 1986). This represents no budget cost savings but does represent a first step in reducing the dependence of Rural Electrification Administration (REA) borrowers on Federal financing. A loan guarantee fee of $3 million should be put into effect as an offset against Agency obligations. Total three-year savings are $10 million.

Conclusions

It is not unreasonable to forecast a 2.5 to 3.5 percent annual growth in load demand for REA power suppliers through 1990. Forecasts are based on numerous factors, including the relative strength of investor-owned utilities. At lower levels of demand and with increased purchase of power supplies from other available sources, REA power suppliers should be able to meet distributors' power demands through the 1980s. Given 7- to 10-year construction lead time, much concern turns on building now to meet the needs of the 1990s and beyond. Shortfalls may exist in certain regions and areas, compounded by potential fuel-related adjustments.

The Government cannot totally extricate itself from the G&T loan-making business due to the need to complete existing projects and to the fact that access to capital markets is not now available for REA G&T borrowers. A weaning and gradual phase-out strategy seems more appropriate.

General financial market access is not now available to G&T long-term borrowers except in special situations and for a limited number of large suppliers.

However, a substantial reduction in the annual loan guarantee limits can be justified based on slack demand for new loans, excess capacity in many areas, and the reworking of power sales agreements between REA borrowers and both Government and private industry suppliers.

Supplemental financing is a feasible and desirable goal.

Loan guarantees are not "costless" loans. In addition to the risk of delinquencies and defaults, the limited pool of available credit, when used for unnecessary or unproductive purposes, finances a low rate of economic growth.

CFC and REA are working quite well together and are learning to complement one another on lending agreements and use of their respective powers and financing capacity.

Recommendations

AG 56-1: The REA annual loan guarantee level for electric borrowers should be reduced by 40 percent over the next four years from $4.745 billion in FY 1983 to a target of $3 billion by FY 1986.

AG 56-2: Power supply borrowers should be required to seek supplemental financing from non-REA sources. A ten percent outside financing would be appropriate as a general rule, but additional amounts could be required of larger suppliers, some of which are no longer tax-exempt organizations.

AG 56-3: A "credit elsewhere" test should be made prior to, and as part of, the overall REA loan guarantee process.

AG 56-4: REA should strengthen its loan guarantee criteria by compelling borrowers to go through uniform forecasting exercises to determine whether power supplies can be obtained elsewhere, rather than through new or expanded construction.

To assist borrowers in obtaining supplemental financing, REA must begin now to promote borrower financial strengths. Among other things, this means strengthening its lending criteria and administrative leverage. More than strengthening TIERs and equity ratios of power suppliers, the focus should be on distribution members--their TIERs, equity ratios, and long-term power purchase agreements with suppliers. Creditworthiness of G&T borrowers is really a function of the creditworthiness of distribution borrowers. Stop orders should be used more frequently when TIERs and debt service coverage fall below acceptable margins, and borrowers should be required to come up with acceptable management plans before financing is resumed.

In developing terms and conditions for supplemental financing, REA will have to develop more flexible loan arrangements with lenders as well as make stronger assurances regarding rate increases and in obtaining enforceable commitments from borrowers.

AG 56-5: REA should charge a loan guarantee fee of roughly $3 million annually to cover the administrative costs associated with running the loan guarantee program.

AG 57: Reduce Government Financing of Cooperatives

Issue and Savings

The Rural Electrification Administration (REA) should expand the use of outside financing for electric distribution cooperatives by expanding supplemental lending ratios to 50-50, increasing insured loan rates to 8 percent, and strengthening borrow "times interest earned" ratios (TIER) and equity ratios. By charging a loan fee and by reducing REA borrowing from the Treasury, direct savings of $10 million and a $30 million cost avoidance will occur in FY 1984, or $132 million over three years. A balanced Rural Electrification and Telephone revolving fund and repayment of $7.8 billion in notes owed the Treasury beginning in 1993 will result in a cost avoidance of that amount after 1993.

Conclusions

Non-REA funding for distribution borrowers is available and can be expanded from borrowers' own sources, provided that REA and Congress reach this policy determination.

By increasing lending ratios from 70-30 to 50-50, the CFC and its affiliated cooperative membership will have the encouragement needed to expand CFC's equity base and to improve the financial position of members. So, too, REA interest rates on insured loans should be increased to 8 percent, and allowed to float thereafter depending on the steps necessary to achieve a Revolving Fund loan balance.

The condition of the Revolving Fund cannot be ignored by REA, NRECA, and the Congress. Necessary corrections should be made and loan forgiveness should be avoided.

The TIERs and equity ratios of REA borrowers should be strengthened over time and appropriate sanctions applied to noncompliance with loan agreements. CFC needs such strengthening to expand its capital base and to gain access to financial markets.

REA should be more aggressive in promoting mergers and consolidation among borrowers.

As lending ratios increase and as non-REA lending grows, the entire management focus of REA also should change. A new orientation suggests a more traditional lender-borrower relationship than the paternalistic relationship that now prevails between REA and its cooperative constituency.

Recommendations

AG 57-1: REA should develop a strategic plan that guides multiyear progress toward encouraging and promoting borrower self-sufficiency.

AG 57-2: REA should implement a 50-50 lending ratio within current full-use constraints and eliminate the special 90-10 ratio for 5 percent insured loans.

AG 57-3: REA should increase TIER levels and equity ratios of borrowers on an annualized basis with enforcement of sanctions against borrowers whose financial condition deviates from such standards.

AG 57-4: REA should increase the 5 percent insured loan level to 9 percent.

AG 57-5: The insured loan program's amortization periods should be shortened from 35 years to 25 years to increase the Revolving Fund's cash flow and to reflect shorter loan maturation schedules of non-REA lenders.

AG 57-6: A one-time loan fee of 1 percent should be charged to borrowers at the time loans are advanced to cover the $10 million annual administrative cost associated with REA's insured loan program.

AG 58: Reduce Regulation

Issue and Savings

The Rural Electrification Administration (REA) should reduce unessential regulation of and services for its borrowers. Savings in FY 1984 would be $1 million, with $3.3 million over three years.

Conclusions

Less frequent audits, more targeting of audit resources, and less oversight of borrowers' total accounting systems would yield cost savings and more effective use of REA resources.

REA's standard specifications can be reduced, streamlined, and, in many detailed prescriptions, simply eliminated without impairing program standardization or REA loan security.

Several of REA's tasks and activities more appropriately characterize an agency and its constitutencies in an embryonic period of development rather than in the mature stage to which both have graduated. REA can no longer do some tasks well and others can be better performed elsewhere--research and development, testing, technology advancement.

One cannot very well redefine the borrower's relationships to its creditor without redefining the creditor's relationship to its borrowers. Deregulation and selective service reduction are critical to redefining REA's current and prospective roles.

Borrowers are far more concerned about other Government regulations than about those imposed by REA.

Overregulation exists in accounting and auditing systems, in materials specified in construction and operation, and in services that either are no longer necessary or simply perpetuate a borrower's dependency on the Government.

The CFC and NRECA can perform many of REA's existing activities. They will have to perform some as a result of increased CFC financing.

Substantial reductions in management services can be made without impairing REA's programs.

REA audits of a borrower's use of Government-supplied loans should be optional to the borrower--either made part of the loan fee schedule or conducted by outside auditors at a reduced REA loan fee schedule.

Spot audits should replace three-year borrower audit schedules. Audit resources can be better targeted to problem cases, with more attention devoted to power supply cost overruns. Many management-related activities are left to the borrower and its trade association.

REA should get out of material and product specification; move to a more managerial posture rather than narrow, technical involvement in borrowers' operation; and leave to other code- and standard-setting bodies many of these tasks.

A general mismatch exists between current REA staffing and resources and the specific tasks it attempts to fulfull.

Recommendations

AG 58-1: Reduce auditing and accounting division staff at headquarters level by 20 percent, or 10 people.

AG 58-2: Reduce or eliminate 15 positions in Management Services. Those tasks to be elilminated include labor relations, insurance, member services, community development, rate assistance, member data processing, and OSHA assistance. Reduced staffing includes the area of civil rights, conservation, and general management assistance to borrowers. These tasks and responsibilites aggregate to 16-18 staff years, so a 15-person reduction in force is achievable.

AG 58-3: Eliminate research and development activities in telephone and electric divisions except as they relate to policy development and loan review.

AG 58-4: Reduce power supply lending personnel by six persons, due to reduced loan demand for new facilities, and reduce environmental review personnel by two.

AG 58-5: Reorganize tasks and responsibilites of the Engineering Standards and Telecommunication Engineering and Standards Division from the perspective of general management guidelines rather than engineering specific standardization of products, materials, and construction procedures.

98TH CONGRESS
1ST SESSION

S. 1300

To amend the Rural Electrification Act of 1936 to ensure the continued financial integrity of the Rural Electrification and Telephone Revolving Fund, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MAY 17 (legislative day, MAY 16), 1983

Mr. HUDDLESTON (for himself, Mr. COCHRAN, Mr. ZORINSKY, Mr. ANDREWS, Mr. MELCHER, Mr. BOSCHWITZ, Mr. BOREN, Mr. JEPSEN, Mr. PRYOR, Mr. HEFLIN, Mr. DIXON, Mr. SARBANES, Mr. HOLLINGS, Mr. PRESSLER, Mr. EAGLETON, Mr. FORD, Mr. DECONCINI, Mr. BAUCUS, Mr. SASSER, Mr. THURMOND, Mr. EXON, Mr. NUNN, Mr. ABDNOR, Mr. BENTSEN, Mr. JOHNSTON, Mr. HART, Mr. JACKSON, Mr. RANDOLPH, Mr. LONG, Mr. PERCY, and Mr. TOWER) introduced the following bill; which was read twice and referred to the Committee on Agriculture, Nutrition, and Forestry

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A BILL

To amend the Rural Electrification Act of 1936 to ensure the continued financial integrity of the Rural Electrification and Telephone Revolving Fund, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983".

SEC. 2. Section 201 of the Rural Electrification Act of 1936 (7 U.S.C. 922) is amended by striking out the last two sentences and inserting in lieu thereof the following: "Loans under this section shall not be made unless the Administrator finds and certifies that, in the Administrator's judgment, the security therefor is reasonably adequate and such loan will be repaid within the time agreed.".

SEC. 3. Section 203 of the Rural Electrification Act of 1936 (7 U.S.C. 924) is amended to read as follows:

"SEC. 203. (a) As used in this title, the term 'telephone service' shall be deemed to mean any communication service for the transmission of voice, data, sounds, signals, pictures, writing, or signs of all kinds by wire, fiber, radio, light, or other visual or electromagnetic means, and shall include all lines, facilities, or systems used in the rendition of such service; but shall not be deemed to mean message telegram service or community antenna television system services or facilities other than those intended exclusively for educational purposes, or radio broadcasting services or facilities within the meaning of section 3(o) of the Communications Act of 1934, as amended.

"(b) As used in this title, the term 'rural area' shall be deemed to mean any area of the United States not included within the boundaries of any incorporated or unincorporated city, village, or borough having a population in excess of two thousand five hundred inhabitants.".

SEC. 4. Section 302 of the Rural Electrification Act of 1936 (7 U.S.C. 932) is amended by—

(1) in subsection (a), inserting "shall be equity capital of the fund" immediately after "Act";

(2) amending clause (2) of subsection (b) to read as follows:

"(2) payment of principal and interest on loans to the Administrator from the Secretary of the Treasury under section 304(a) of this title and on certificates of beneficial ownership issued to the Secretary of the Treasury or in the private market under section 304(c) of this title;"; and

(3) adding at the end thereof a new subsection (c) as follows:

"(c) The Administrator shall maintain two separate accounts within the fund, to be known as the Electrification Account and the Telephone Account, respectively. The assets, liabilities, income, expenses, and equity of the fund described in section 301 of this Act and subsection (a) of this section that are attributable to the operations of the electric loan program shall be accounted for in the Electrification Account and the assets, liabilities, income, expenses, and equity of the fund so described that are attributable to the operations of the telephone loan program shall be accounted for in the Telephone Account. The assets accounted for in the

Electrification Account shall be available only for the purposes described in subsection (b) of this section relating to the operations of the electric loan program, and the assets accounted for in the Telephone Account shall be available only for the purposes described in subsection (b) of this section relating to the operations of the telephone loan program.".

SEC. 5. Section 304 of the Rural Electrification Act of 1936 (7 U.S.C. 934) is amended by adding a new sentence at the end of subsection (c) as follows: "Whenever the interest rate on any certificate of beneficial ownership that has a remaining term of seven years or more and that is issued by the Administrator and purchased under this subsection exceeds the rate of interest applicable to other similar certificates then being purchased by one hundred basis points (1 per centum) or more, the Administrator is authorized to repurchase the certificate. Such repurchase shall be made without penalty.".

SEC. 6. Section 305 of the Rural Electrification Act of 1936 (7 U.S.C. 935) is amended by—

(1) amending subsection (b) to read as follows:

"(b) Insured loans made under this title from each account in the fund shall bear interest at a rate (hereinafter in this section referred to as the 'standard rate') that shall be established by the Administrator and adjusted thereafter from time to time, under rules and regulations to be promulgated within one hundred and twenty days after the effective date of the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983. Such rules and regulations shall provide that the standard rate for each account shall be that rate, not less than 5 per centum per annum, that would produce, from loans (other than special rate loans) approved from that account during a given period, interest income equal to, but not greater than, the amount of anticipated interest expense on the account's obligations (interim notes, insured notes, and certificates of beneficial ownership) required to be issued or sold during such period to cover loan advances and interest expenses: *Provided,* That the amount of such obligations to be issued or sold for such purposes shall be determined by deducting the sum of principal and interest receipts and any appropriation under subsection (c) of this section from the sum of loan advances and interest expenses on outstanding obligations of the account during such period. The standard rate, as established by the Administrator, and any adjustment thereto shall be made having due regard for the objectives of this Act and shall be applicable only to loans made after the effective date of such establishment or adjustment. The Administrator may make insured loans to electric or telephone borrowers at a lesser interstate rate, but not less than 2 per centum per annum nor more than a rate equal to one-half the standard rate (hereinafter in this section referred to as the 'special rate') if the Administrator finds, under guidelines to be established within one hundred and twenty days after the effective date of the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983, that the borrower—

"(1)(A) charges rates exceeding twice the national average of rates charged by borrowers in the same program, or cannot provide service consistent with the objectives of this Act without charging rates (established in accordance with generally accepted management and accounting principles) so high as to create a substantial disparity between such rates and the rates charged for similar service in the same or nearby areas by other suppliers; or

"(B) has an average consumer density of two or fewer per mile of line; or

"(C) has experienced financial losses attributable to storm damage, natural disasters, or other occurrences beyond its control; or

"(D) serves geographic areas having unusually low per capita income; and

"(2) is experiencing financial or other hardship through extenuating circumstances.

The rules and regulations promulgated under this subsection shall not take effect until (1) such rules and regulations have been transmitted to the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agriculture and (2) the expiration of thirty calendar days of continuous session of Congress after the date of such transmittal.";

(2) redesignating subsection (c) as subsection (d), and in subsection (d), as so redesignated, striking out "; such loans shall be sold and insured by the Administrator without undue delay"; and

(3) inserting, after subsection (b), a new subsection (c) as follows:

"(c) The Secretary of Agriculture shall include in each annual supplemental budget estimate or request submitted to the President or the Office of Management and Budget, and shall concurrently submit to the House Committee on Appropriations, the Senate Committee on Appropriations, the House Committee on Agriculture, and the Senate Committee on Agriculture, Nutrition, and Forestry, a request for the amount of funds determined by the Administrator to be necessary to replenish the fund for all actual and anticipated costs to the fund resulting from loans made at less than the standard rate during the preceding fiscal year.".

SEC. 7. Section 306 of the Rural Electrification Act of 1936 (7 U.S.C. 1936) is amended by—

(1) inserting "(a)" immediately after the section designation;

(2) striking out the first sentence and inserting in lieu thereof the following: "For the purposes of (1) encouraging and assisting borrowers to develop and achieve the financial strength necessary to satisfy their credit needs from other sources and (2) improving the financial stability of borrowers, the Administrator, consistent with the objectives of this Act and in accordance with the rules and regulations to be promulgated under subsection (b) of this section, shall provide financial assistance to borrowers for purposes provided in this Act and for purposes of providing refinancing assistance, by guaranteeing loans, in the full amount thereof, made by the Rural Telephone Bank, the National Rural Utilities Cooperative Finance Corporation, and any other legally organized lending agency or lender approved by the Administrator, or by accommodating or subordinating liens or mortgages in the fund held by the Administrator as owner or as trustee or custodian for purchases of notes from the fund, or by any combination of such guarantee, accommodation, or subordination. The Administrator shall accommodate or subordinate liens or mortgages at the request of the borrower, notwithstanding any other provision of this

Act, for any purpose that would enhance the financial strength or revenue of the borrower or improve the efficiency, effectiveness, or financial stability of the borrower, upon a finding that the borrower has, or will have, the ability to repay its existing and proposed indebtedness.";

(3) striking out the penultimate sentence and inserting in lieu thereof the following: "As used in this title, a guaranteed loan is one that is initially made or refinanced, held, and serviced by a legally organized agency or lender approved by the Administrator and that is guaranteed by the Administrator hereunder."; and

(4) adding at the end thereof new subsections (b) and (c) as follows:

"(b) Not later than ninety days after the effective date of the Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983, the Administrator shall promulgate rules and regulations for the guarantee of loans and the accommodation and subordination of liens or mortgages, as provided in subsection (a) of this section. The rules and regulations promulgated under this subsection shall not take effect until (1) such rules and regulations have been transmitted to the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agriculture and (2) the expiration of thirty calendar days of continuous session of Congress after the date of such transmittal.

"(c) Whenever the interest rate on any advance under a loan that has a remaining term of seven years or more and that is guaranteed by the Administrator and made by a lender under this section exceeds the rate of interest applicable on other similar new advances than being made or purchased by one hundred basis points (1 per centum) or more, the lender is authorized, upon the request of the borrower, to adjust the interest rate on such advance, without penalty , to the interest rate then applicable to other similar new advances then being made or purchased by the lender: *Provided,* That no interest rate on such advance shall be readjusted at intervals of less than seven years.".

SEC. 8. Section 307 of the Rural Electrification Act of 1936 (7 U.S.C. 937) is amended by inserting before the period at the end thereof a colon and a proviso as follows: "*Provided,* That in any fiscal year for which the minimum loan level, as established by law, is less than $1,000,000,000 for insured loans for rural electrification, rural electrification borrowers shall obtain concurrent supplemental financing in accordance with the applicable criteria and ratios in effect for fiscal year 1983 under Public Law 97-370, 96 Stat. 1801, enacted December 18, 1982".

SEC. 9. Section 406(a) of the Rural Electrification Act of 1936 (7 U.S.C. 946(a)) is amended by striking out "but not later than fiscal year 1991" in the second sentence.

SEC. 10. Section 408 of the Rural Electrification Act of 1936 (7 U.S.C. 948) is amended by—

(1) striking out everything in the first sentence of subsection (a) after "class C stock" down through the end of the sentence and inserting in lieu thereof a period;

(2) in paragraph (4) of subsection (b), adding "and income taxes" after "before interest", and striking out "higher" and inserting in lieu thereof "other"; and

(3) striking out paragraph (5) of subsection (b) in its entirety and redesignating paragraphs (6) and (7) of subsection (b) as paragraphs (5) and (6), respectively.

SEC. 11. Section 410 of the Rural Electrification Act of 1936 (7 U.S.C. 950) is amended by striking out subsection (b) in its entirety and by redesignating subsection (c) as subsection (b).

SEC. 12. This Act shall become effective on the date of enactment: *Provided*, That during the period between the effective date of this Act and the effective date of the rules and regulations required to be promulgated under section 305(b) of the Rural Electrification Act of 1936, as amended herein, the Administrator of the Rural Electrification Administration shall continue to make insured loans under the Rural Electrification Act of 1936 at the interest rates specified in section 305(b) prior to its amendment by this Act.

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